Budget 2015 - Canada

Tax Bulletin

The Minister of Finance (Canada), the Honourable Joe Oliver, presented the Government of Canada's 2015 Federal Budget ("Budget 2015") on April 21, 2015 ("Budget Day"). Budget 2015 contains several significant proposals to amend the *Income Tax Act* (Canada) (the "ITA") while also providing updates on previously announced tax measures and policies.

Significant Budget 2015 proposals include:

- reducing the small business tax rate effective for years after 2015 to 9% by 2019;
- new anti-avoidance rules applicable to synthetic equity arrangements and capital gains stripping;
- withholding exemption for non-resident employers and streamlined reporting requirements for foreign assets;
- expansion of the captive insurance anti-avoidance rule in the foreign affiliate regime; and
- updates on Canada's participation in the OECD's Action Plan on Base Erosion and Profit Shifting and the automatic exchange of tax information regime between Canada and other countries.

Business Income Tax Measures

Small Business Tax Rate

Currently, the income tax rate applicable to the first $500,000 of qualifying active business income of a Canadian-controlled private corporation (a "CCPC") is reduced from 15% to 11% (the "small business tax rate"). Budget 2015 proposes to reduce the small business tax rate to 9% by January 1, 2019. More specifically, the small business tax rate applicable to the first $500,000 of qualifying active business income of a CCPC will be reduced as follows:

- effective January 1, 2016, the rate will be reduced to 10.5%;
- effective January 1, 2017, the rate will be reduced to 10%;
- effective January 1, 2018, the rate will be reduced to 9.5%; and
- effective January 1, 2019, the rate will be reduced to 9%.

At the same time, Budget 2015 proposes to address the gross-up and tax credit rules in the ITA applicable to dividends paid by corporations to individuals. Very generally, the purpose of the gross-up and tax credit rules is to compensate an individual receiving dividends for corporate income tax which is presumed to have already been paid on the income of a corporation which funded the dividends paid to the individual. To achieve this, the ITA grosses up dividends paid by a corporation to an individual (theoretically, to

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the amount of pre-tax income which funded the dividends) and then permits the individual to claim a dividend tax credit (theoretically, equal to the income tax paid by the corporation on the funds used by the corporation to pay the dividends). However, to achieve this objective, the dividend gross-up and tax credit mechanisms address the fact that CCPCs are only subject to the small business tax rate on the first $500,000 of qualifying active business income.

Given the further proposed reductions to the small business tax rate on qualifying active business income earned by CCPCs, Budget 2015 proposes to reduce the gross-up factor and dividend tax credit applicable to dividends paid from corporate income which benefitted from the small business tax rate. Budget 2015 proposes to adjust the gross-up factor and dividend tax credit over time as follows:

- effective January 1, 2016, the gross-up applicable to non-eligible dividends will be decreased from 18% to 17% and the corresponding dividend tax credit will be adjusted from 13/18 to 21/29 of the gross-up amount;
- effective January 1, 2018, the gross-up applicable to non-eligible dividends will be further decreased from 17% to 16% and the corresponding dividend tax credit will be adjusted from 21/29 to 20/29; and
- effective January 1, 2019, the gross-up applicable to non-eligible dividends will be decreased from 16% to 15% and the corresponding dividend tax credit will be adjusted from 20/29 to 9/13.

Thus, as the small business tax rate decreases as proposed by Budget 2015, so too will the effective rate of the dividend tax credit in respect of dividends paid by corporations to individuals from funds which benefitted from the small business tax rate.

Synthetic Equity Arrangements

Budget 2015 contains proposals aimed at eliminating tax avoidance associated with "synthetic equity arrangements" ("SEAs"). Generally, an SEA involves a corporation that receives dividends of a Canadian corporation tax-free because such corporation is entitled to claim a deduction under section 112 of the ITA equal to the amount of the dividends received. An SEA is a financial arrangement where a corporate taxpayer retains the legal ownership of a share of a Canadian corporation but the opportunity for gain and the risk of loss in respect of the share is transferred to a counterparty using an equity derivative. Under the terms of the equity derivative, the taxpayer is obliged to pay to the counterparty amounts equal to the economic benefit of any dividends received on the shares. In these circumstances, the taxpayer realizes a loss for Canadian tax purposes because the receipt of dividends on the shares is not taxed in the hands of the taxpayer and the taxpayer also claims a deduction for the amount of the "dividend equivalent payments" paid to the counterparty.

The dividend rental arrangement rules apply to deny the inter-corporate dividend deduction under section 112 where it can reasonably be considered that the main reason for the arrangement is to enable the shareholder to receive a dividend on a share and someone other than the dividend recipient bears the risk of loss or opportunity for gain or profit in any material respect. To the extent that the taxpayer relies on a position that the dividend rental arrangement rules do not apply to an SEA, there is said to be an erosion of Canada's tax base when the counterparty is a "tax-indifferent investor" that is not subject to Canadian tax on the dividend equivalent payment (for example, a non-resident of Canada or a tax-exempt entity).

Budget 2015 proposes substantial amendments to the ITA that modify the dividend rental arrangement rules to include specific provisions applicable to SEAs (as defined in the proposals) which are intended to ensure the denial of the tax benefits of an SEA. An SEA will also be deemed to exist where a person that does not deal at arm' length with the taxpayer enters into an arrangement if such person knew or ought to have known that the tax benefits of an SEA would result.

The draft proposals included in Budget 2015 also provide certain exceptions to the broadened dividend rental arrangement rules. For instance, an exception will apply where a taxpayer can establish that no tax-indifferent investor has all or substantially all of the risk of loss or opportunity for gain or profit in respect of the share by virtue of an SEA or another equity derivative that is entered into in connection with the SEA. There is also an exception for arrangements that are traded on a "recognized derivative exchange" unless it can reasonably be considered that the taxpayer knows, or ought to know, the identity of the counterparty.

A broad anti-avoidance rule is also proposed that deems certain arrangements that would not otherwise be caught within the new SEA definition to still be considered a dividend rental arrangement where one of the purposes of a series of transactions that includes an arrangement that has the effect of eliminating all or substantially all of the taxpayer's risk of loss or opportunity for gain or profit in respect of a share is to avoid these new rules.

These proposed amendments will apply to dividends that are paid or become payable after October 2015. However, Budget 2015 also expressed a willingness on the part of the Government to expand these rules to deny the inter-corporate dividend deduction on dividends in all circumstances where the shareholder does not bear the risk of loss or enjoy the opportunity for gain or profit even where the counterparty is not a tax-indifferent investor. The Government has called for submissions from stakeholders regarding whether this expanded alternative should be pursued and such submissions are due by August 31, 2015.

Tax Avoidance of Corporate Capital Gains

Budget 2015 proposes significant changes to the structure and application of section 55. Section 55 generally applies to a dividend where, among other things, one of the purposes of the dividend was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition of a share at its fair market value, unless an exception is available.

Where section 55 applies, the dividend is treated either as proceeds of disposition if the corporation disposed of the share or as a gain from the disposition of capital property where the corporation has not disposed of the share.

Budget 2015 proposes to expand the rule in section 55 to apply where dividends are paid on a share not only to reduce a capital gain on that share but also where one of the purposes of a dividend is to cause the fair market value of the share to fall below its cost or to cause a significant increase in the total cost of properties of the recipient of the dividend.

The amendments are in response to a decision of the Tax Court of Canada (*D & D Livestock Ltd. v. R.*, 2013 TCC 318) which held that section 55 did not apply where the effect of a dividend in kind (consisting of shares of another corporation) was to create an unrealized capital loss on the shares. This unrealized loss was then available to be used to offset capital gains realized on the sale of other property.

Budget 2015 proposes to introduce related proposals to ensure that the new rule is not circumvented. Special rules may apply in respect of stock dividends depending on the fair market value of the shares issued relative to the increase in the paid-up capital of the corporation. A dividend to which the proposed anti-avoidance rule applies is to be treated as a gain from the disposition of capital property.

Budget 2015 also proposes to restrict the exception for certain related party transactions to dividends deemed received as a result of the redemption, acquisition or cancellation of shares.

This measure will apply to dividends received by a corporation on or after Budget Day.

Consultation on Eligible Capital Property

The Canadian Government announced in the 2014 Federal Budget ("Budget 2014") that it would start public consultations on changing the eligible capital property regime into a capital cost allowance regime. In Budget 2015, the Government says that it is continuing to receive submissions on this proposal and will consider all representations in developing the new rules (including transitional rules). The Government will release detailed legislative proposals for stakeholder comment before including them in a bill.

International Tax Measures

Withholding for Non-Resident Employers

It is quite common for non-resident employers to send their employees to Canada to perform work for short periods of time. Under the ITA, subject to obtaining a waiver from the Canada Revenue Agency (the "CRA"), such employers are required to withhold and remit income tax in respect of the income earned by the employees from employment in Canada. This is the case, even where the non-resident employees may ultimately have no Canadian income tax liability in respect of employment income earned in Canada, owing to the application of an income tax treaty between Canada and the country in which the employees are resident. In such circumstances, the non-resident employees must file Canadian income tax returns, claiming exemption from Canadian income tax under the applicable treaty, in order to obtain a refund of the income tax withheld and remitted by their employers. This system is cumbersome and administratively burdensome for non-resident employers and non-resident employees, particularly in light of modern business realities.

Budget 2015 attempts to address this issue by proposing an exception to the above-mentioned withholding requirement if the employer and employee meet the newly proposed criteria to qualify, respectively, as a "qualifying non-resident employer" and a "qualifying non-resident employee," in respect of a payment for employment services performed in Canada. As proposed by Budget 2015, an employer will be a "qualifying non-resident employer" in the following circumstances:

- the employer (other than a partnership) must be resident in a country with which Canada has a tax treaty;
- if the employer is a partnership, at least 90% of the partnership's income for the fiscal period that includes the time of payment must be allocated to persons that are residents in a treaty country;
- in either of the above scenarios, the employer must not carry on business through a Canadian permanent establishment (what constitutes a "permanent establishment" is determined in accordance with the terms of the relevant tax treaty between the country in which the non-resident employer is resident and Canada) of the employer

in its fiscal period that includes the time of the payments and the employer must be certified by the Minister of National Revenue at the time of the payment. In order to become "certified," the non-resident employer must apply to the Minister of National Revenue using a prescribed form. Such "certification" is proposed to only be provided for a specified period of time (i.e., a non-resident corporation once certified is not forever certified) and may be revoked.

Budget 2015 proposes that an employee will be a "qualifying non-resident employee" in respect of a payment if the employee:

- is, at that time, resident in a country with which Canada has a tax treaty;
- is not liable to tax under Part I of the ITA in respect of the payment because of that treaty; and
- is not present in Canada for 90 or more days in any 12-month period that includes the time of payment.

While this proposed measure will be welcomed by the business community, the measure does not completely eliminate a non-resident employer's responsibility, or potential liability, with respect to payments to non-resident employees for employment exercised in Canada, even if the employer is a "qualifying non-resident employer". Budget 2015 states that a "qualifying non-resident employer" must still fulfill its reporting requirements under the ITA with respect to amounts paid to non-resident employees for employment services rendered in Canada and that such an employer will continue to be liable for any amounts required to be withheld and remitted to the CRA in respect of payments to non-resident employees who are not "qualifying non-resident employees". However, Budget 2015 also proposes a due diligence-type defence for employers in that a "qualifying non-resident employer" will not be liable for penalties under the ITA for failing to withhold and remit income tax from payments to non-resident employees for employment exercised in Canada if, after reasonable inquiry, the employer had no reason to believe, at the time of payment, that the employee did not meet the conditions to be a "qualifying non-resident employee".

This measure will apply in respect of payments made after 2015.

Streamlining Reporting Requirements for Foreign Assets
Canadian resident individuals, corporations, trusts and, in certain circumstances, partnerships, which, at any time in a taxation year own "specified foreign property" with a total cost of more than $100,000, must file Form T1135 "Foreign Income Verification Statement" ("Form T1135") with the CRA. "Specified foreign property" is defined in the ITA, to include, among other property, funds and investments situated, deposited or held outside Canada. Certain property, such as property used exclusively in carrying on an active business, real estate and other property that is for personal use and shares and indebtedness of a foreign affiliate of the Canadian taxpayer is excluded from being specified foreign property. Property held in registered plans, such as RRSPs and TFSAs, is excluded from the reporting requirement.

In 2013, the CRA revised Form T1135. The revised form required taxpayers subject to Form T1135 filing requirements to disclose significantly more details about each specified foreign property. The more detailed Form T1135 was, at the time, justified by the Government of Canada and the CRA as being necessary in order to strengthen their ability to combat international tax evasion and aggressive tax avoidance. However, given the extent of the detail required in the revised Form T1135, taxpayers voiced concerns regarding that the compliance burden for some taxpayers was disproportionate to the amount of their specified foreign property.

Budget 2015 proposes an alternative, simplified, Form T1135 (being developed by the CRA) for use by taxpayers, if the total cost of a taxpayer's specified foreign property is less than $250,000 throughout the year. If the taxpayer meets the prerequisites, the taxpayer will be entitled to utilize the proposed simplified Form T1135 for taxation years beginning after 2014. Taxpayers with specified foreign property with a total cost at any time during the year of $250,000 or more, will still be required to use the more detailed Form T1135 developed by the CRA in 2013.

Captive Insurance

The Canadian Government wants to ensure that Canadian taxpayers are not moving income from the insurance of Canadian risks offshore. Canadian risks are risks in respect of Canadian resident persons, Canada-situate property and Canadian businesses.

Budget 2014 introduced a new rule that deems a foreign affiliate's income from certain insurance swaps to be foreign accrual property income ("FAPI"). Under such swaps, a foreign affiliate retains economic exposure to Canadian risks while ensuring foreign risks.

Budget 2015 expands the 2014 change to catch ceding transactions with similar tax benefits. Thus, for taxation years beginning after April 20, 2015, a foreign affiliate's income from ceding Canadian risks will be included in FAPI. For this purpose, if a foreign affiliate cedes Canadian risks in return for a portfolio of insured foreign risks, the affiliate will have FAPI equal to the fair market value of the ceded Canadian risks less the costs in respect of those risks.

The Government is inviting interested parties to make submissions on this measure by June 30, 2015.

pdate on Tax Planning by Multinational Enterprises

Canada has been an active participant and vocal supporter of the G20/OECD Action Plan on Base Erosion and Profit Shifting ("BEPS") which was released in July 2013. Budget 2015 reiterates the Government's support for the Action Plan on BEPS and states that the Government "looks forward to the conclusion of the project and to discussions with the international community on the implementation of its recommendations." Interestingly, the Government does not promise to await the outcome of the BEPS recommendations before making changes to Canada's system of international taxation. Other countries, including Australia, Austria and the U.K., have recently brought in new BEPS-inspired tax legislation creating perceived challenges for the largely consensus-driven OECD Action Plan.

pdate on Automatic Exchange of Tax Information

In Budget 2015, the Government notes that Canada and the other G20 countries recently endorsed a new common reporting standard for the automatic exchange of tax information. The new standard provides that the CRA and a foreign tax authority will provide information to each other regarding financial accounts held by residents of the other jurisdiction. Canada proposes to implement the new standard effective July 1, 2017, with a first exchange occurring in 2018. Financial institutions are expected to have procedures in place by the implementation date to identify non-resident accounts and report certain information relating to the accounts to the CRA. Once the CRA is satisfied that a foreign jurisdiction has the appropriate capacity and taxpayer confidentiality safeguards, the CRA will enter into an exchange agreement with that jurisdiction and start to exchange information.

The Government intends to release draft legislative proposals in the months ahead.

Personal Income Tax Measures

Tax-Free Savings Account

Effective January 1, 2015, Budget 2015 proposes to increase the annual TFSA contribution limit to $10,000. The annual contribution limit is currently $5,500, up from $5,000, when the TFSA was originally introduced in 2009. Contributions to a TFSA are not deductible, but income earned in and withdrawals from a TFSA are tax-free. The TFSA annual contribution limit will no longer be indexed to inflation.

Lifetime Capital Gains Exemption for ualified Farm or Fishing Property

In a move that will be welcomed by farmers and fisherman alike, Budget 2015 proposes to increase the maximum lifetime capital gains exemption from $813,600 to $1,000,000 of capital gains ($500,000 of taxable capital gains) realized by an individual on the disposition of "qualified farm or fishing property," as defined in the ITA. The proposed increase to the maximum lifetime capital gains exemption applies to dispositions of "qualified farm or fishing property" which occur on or after Budget Day.

Repeated Failure to Report Income Penalty

Currently, where a taxpayer fails to report an amount of income in a taxation year and has failed to report an amount of income in any of the three preceding taxation years, the taxpayer is liable to a penalty of 10% of the unreported income amount. The repeated failure to report income penalty does not apply where the "gross negligence" penalty applies.

Budget 2015 proposes relieving amendments so that the repeated failure to report income penalty will apply in a tax year only if a taxpayer fails to report at least $500 of income in the year and in any of the three preceding taxation years. Under the new rules, the amount of the repeated failure to report income penalty will be equal to the lesser of:

- 10% of the amount of unreported income; and
- An amount equal to 50% of the difference between the resulting understatement of tax (or overstatement of credits) and the amount of tax paid in respect of the unreported amount.

There will be no changes to the application of the gross negligence penalty. The gross negligence penalty generally applies where a taxpayer fails to report income intentionally or in circumstances amounting to gross negligence.

This measure will apply to the 2015 and subsequent taxation years.

Alternative Arguments in Support of Assessments

Long standing tax jurisprudence had established that on appeal from a tax assessment, although the total amount from all sources that is assessed cannot increase after the expiration of the normal reassessment period, the underlying basis of the assessment can change. However, a recent court decision (*Last v. R.*, 2014 FCA 129) held that, while the basis of an assessment can be changed after the expiration of the normal reassessment period, each original source of income is to be considered in isolation and the amount of the assessment in respect of any particular source of income cannot increase.

Budget 2015 proposes an amendment to the ITA to clarify that the CRA and the courts may increase or adjust an amount included in an assessment that is under objection or appeal at any time, provided the total amount of the assessment does not increase.

Similar amendments are proposed to be made to Part IX of the *xcise Tax Act* and the *xcise Act* .

These measures will apply to appeals instituted after Royal Assent to the enacting legislation.

Information Sharing for the Collection of Non-Tax Debts
The CRA collects non-tax debts owing to the federal and provincial governments. Currently, confidential taxpayer information cannot be used by the CRA to collect these non-tax debts. This forces the CRA to separate its tax and non-tax debt collection leading to inefficiencies and redundancies.

Budget 2015 proposes to amend the ITA Part IX of the *xcise Tax Act* and the *xcise Act* to permit the sharing of confidential taxpayer information within the CRA in respect of non-tax debts owed to the Federal and Provincial governments.

In addition, Budget 2015 also proposes to amend Part IX of the *xcise Tax Act* and the *xcise Act* to permit information sharing in respect of certain programs where such information sharing is currently permitted under the ITA.

These measures will apply on Royal Assent to the enacting legislation.

Charities Measures

Donations Involving Private Corporation Shares or Real Estate
If private company shares or real estate are sold in an arm's length transaction and the cash proceeds of sale are donated to a registered charity or qualified donee within 30 days of the disposition, subject to anti-avoidance rules, the realized capital gain will be tax exempt. If only a portion of the sale proceeds is donated, that proportion of the capital gain will be exempt from tax. On a real estate sale, presumably the ordinary tax rules on the recapture of capital cost allowance will continue to apply.

This measure will apply to donations in respect of dispositions occurring after 2016.

Investments by Registered Charities in Limited Partnerships
Registered charities and registered Canadian amateur athletic associations will now be permitted to invest in limited partnerships without being deemed to carry on business as a result of that investment. There are two provisos. The charity or amateur athletic association must deal at arm's length with each general partner and the holding, including holdings of persons not acting at arm's length with the charity or amateur athletic association, must not exceed 20% of the fair market value of the partnership.

This measure applies in respect of investments in limited partnerships that are made or acquired on or after Budget Day.

Gifts to Foreign Charitable Foundations
A foreign charity will be able to be registered as a qualified donee and consequently a potential recipient of gifts from a Canadian charity for a 24-month period if the

Government of Canada has made a contribution to the foreign charity and the foreign charity carries on activities related to disaster relief or urgent humanitarian needs, or activities in the national interest of Canada. This proposed provision appears similar to the existing statutory provision.

These measures will apply on Royal Assent to the enacting legislation.

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