

Business Income Tax Commentary- 2017 Federal Budget

Investment Fund Managers

Merger of switch corporations into mutual fund trusts

Budget 2017 proposes to facilitate the reorganization of a mutual fund corporation that is structured as a switch corporation into multiple mutual fund trusts on a tax-deferred basis.

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

Segregated fund mergers

To provide consistent treatment between mutual fund trusts and segregated funds, Budget 2017 proposes to allow insurers to effect tax-deferred mergers of segregated funds. It is proposed that these rules generally parallel the mutual fund merger rules.

This measure will apply to mergers of segregated funds carried out after 2017.

Clean Energy Generation Equipment: Geothermal Energy

Budget 2017 proposes that eligible geothermal energy equipment under Classes 43.1 and 43.2 be expanded to include geothermal equipment that is used primarily for the purpose of generating heat or a combination of heat and electricity. Eligible costs will include the cost of completing a geothermal well (e.g., installing the wellhead and production string) and, for systems that produce electricity, the cost of related electricity transmission equipment.

Secondly, geothermal heating will be made an eligible thermal energy source for use in a district energy system.

Lastly, expenses incurred for the purpose of determining the extent and quality of a geothermal resource and the cost of all geothermal drilling (e.g., including geothermal production wells), for both electricity and heating projects, will qualify as a Canadian renewable and conservation expense.

The 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.

Canadian Exploration Expenses: Oil and Gas Discovery Wells

Budget 2017 proposes that expenditures related to drilling or completing a discovery well (or in building a temporary access road to, or in preparing a site in respect of, any such well) generally be classified as Canadian development expenses (CDE) instead of Canadian exploration expenses (CEE).

This measure will apply to expenses incurred after 2018 (including expenses incurred in 2019 that could have been deemed to have been incurred in 2018 because of the “look-back” rule). However, the measure will not apply to expenses actually incurred before 2021 where the taxpayer has, before Budget Day, entered into a written commitment (including a commitment to a government under the terms of a license or permit) to incur those expenses.

Reclassification of Expenses Renounced to Flow-Through Share Investors

An eligible small oil and gas corporation (i.e., with taxable capital employed in Canada of not more than \$15 million) can currently treat up to \$1 million of Canadian development expenses (CDE) as Canadian exploration expenses (CEE) when renounced to shareholders under a flow-through share agreement. CDE is deductible at a rate of 30 per cent per year on a declining-balance basis. CEE is fully deductible in the year it is incurred. Budget 2017 proposes to no longer permit eligible small oil and gas corporations to treat the first \$1 million of CDE as CEE.

This measure will apply in respect of expenses incurred after 2018 (including expenses incurred in 2019 that could have been deemed to be incurred in 2018 because of the look-back rule), with the exception of expenses incurred after 2018 and before April 2019 that are renounced under a flow-through share agreement entered into after 2016 and before Budget Day.

Meaning of Factual Control

The factual control (de facto) test is one of the tests used to determine whether two or more Canadian controlled private corporations are “associated corporations”. Factual control of a corporation exists where a person has “directly or indirectly in any manner whatever” influence that, if exercised, would result in control in fact of the corporation. In each situation, consideration of all the relevant factors is required in determining whether there is factual control of a corporation.

A recent Federal Court of Appeal decision (McGillivray Restaurant Ltd. vs. H.M.Q.) held that, in order for a factor to be considered in determining whether factual control exists, it must include “a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability”. Budget 2017 proposes an amendment to clarify that, in determining whether factual control of a corporation exists, factors may be considered that are not limited to the requirement set out above.

This measure will apply in respect of taxation years that begin on or after Budget Day.

Timing of Recognition of Gains and Losses on Derivatives

Budget 2017 proposes to introduce an elective mark-to-market regime for derivatives held on income account. Specifically, an election will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election will remain effective for all subsequent years unless revoked with the consent of the Minister of National Revenue.

Once an election is made by a taxpayer, the taxpayer will be required to annually include in computing its income the increase or decrease in value of its eligible derivatives. Furthermore, the recognition of any accrued gain or loss on an eligible derivative (that was previously subject to tax on a realization basis) at the beginning of the first election year will be deferred until the derivative is disposed of.

This election will be available for taxation years that begin on or after Budget Day.

Derivative Straddle Transactions

Budget 2017 proposes to introduce a specific anti-avoidance rule that targets straddle transactions. In particular, a stop-loss rule will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. A gain in respect of an offsetting position would generally be unrealized where the offsetting position has not been disposed of and is not subject to mark-to-market taxation.

This measure will apply to any loss realized on a position entered into, on or after Budget Day.

Investment Tax Credit for Child Care Spaces

Budget 2017 proposes to eliminate the investment tax credit for child care spaces. This measure will apply in respect of expenditures incurred on or after Budget Day.

To provide transitional relief, the credit will be available in respect of eligible expenditures incurred before 2020 pursuant to a written agreement entered into before Budget Day.

Billed-Basis Accounting

Currently, taxpayers in certain designated professions (i.e., accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of work in progress (WIP) in computing their income. Budget 2017 indicates that this enables these taxpayers to defer tax by permitting the costs associated with WIP to be expensed without the matching inclusion of the associated revenues.

Budget 2017 proposes to eliminate the ability for designated professionals to use billed-basis accounting. For the first taxation year that begins on or after Budget Day, 50 per cent of the lesser of the cost and the fair market value of WIP will be included in income. In subsequent taxation years, the lesser of the cost and the fair market value of WIP will be taken into income.

At present, many professionals either do not account for WIP in their financial accounts, or account for WIP at its expected billing amount, using staff and partner billing rates, rather than cost. These professionals will be required to determine the cost of their WIP in order to comply with these new provisions.

It is unclear how the cost of WIP is to be determined. Hopefully, this will be clarified as the proposal proceeds through the legislative process.

This measure will be effective for taxation years that begin on or after Budget Day, phased in as indicated above.

Cash Purchase Tickets

At present, farmers delivering listed grain (i.e., wheat, oats, barley, rye, flaxseed, rapeseed or canola) to the operator of a licensed elevator may choose to receive a cash purchase ticket (or certain other prescribed forms of settlement). This can be payable in the following taxation year, in which case the farmer defers reporting the income to the following year.

Budget 2017 indicates that the deregulation of the grain marketing regime and commercialization of the Canadian Wheat Board calls into question whether a clear policy rationale for this tax deferral remains. A consultation will be undertaken to assess the ongoing utility, and potential elimination, of this tax deferral, including possible transitional rules.

Comments may be submitted by May 24, 2017 to: consultation_tax_2017@canada.ca.

Private Corporations: Things to Come

Although no changes were proposed, Budget 2017 indicated that the review of federal tax expenditures highlighted a number of issues regarding tax planning strategies using private corporations. The strategies identified are:

- Sprinkling income using private corporations, to family members who are subject to lower personal tax rates.

- Holding a passive investment portfolio inside a private corporation, which may be financially advantageous due to the fact that corporate income tax rates facilitate accumulation of earnings that can be invested in a passive portfolio.
- Converting a private corporation's regular income into capital gains, resulting in lower tax rates.

The Government is further reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes of high-income earners. The Government will also consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members.

The Government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.