Tax and planning

Federal budget 2016

The federal government announced its annual budget on March 22, 2016. This article doesn't contain a complete list of proposals, but outlines the ones that may be relevant to the financial service industry. Please note the announced budget contains proposals that may undergo revisions before becoming law. You may wish to keep in mind that any planning based on proposed rules may need revision should the proposals undergo any changes or are not enacted. Since the government has a majority it's likely that most proposals will eventually become law.

Taxation of switch fund shares

The legal structure of corporate class funds is a mutual fund corporation. This legal structure provides the following tax benefits:

- Potentially lower distributions,
- Preferential treatment of distributions or withdrawals and
- Tax-deferred switching and rebalancing.

Federal budget 2016 proposes eliminating the tax deferred switching benefit from these funds. After September 2016, an exchange of shares of a mutual fund corporation that results in the investor switching between funds will be considered to be a disposition at fair market value (FMV) for tax purposes.

This means investors will have until September 2016 to arrange the allocation of the investments within their corporate class portfolios in a manner that is suitable for their circumstances, while maintaining the tax deferral. After September 2016, any switches or rebalancing will trigger capital gains or losses similar to that of a mutual fund trust.

A switch between series within the same fund will not be viewed as a disposition; therefore, investors can still consider the D-series funding life insurance strategy and can take advantage of high-net worth pricing as they grow their wealth.

Distribution from life insurance policies and credit to capital dividend account or increase in the cost base of partnership interest

Generally, a private corporation's capital dividend account (CDA)[1] is increased by the death benefit of a life insurance policy less the adjusted cost basis (ACB). The positive balance in the CDA can be distributed to Canadian resident shareholders as a tax-free capital dividend. Where the policyowner and the beneficiary are different corporations, the death benefit is received by one corporation, while the ACB of the policy is in another corporation. In this case, it may be possible for the beneficiary corporation to credit the entire death benefit (instead of reducing it by the ACB of the policy) to its CDA, and pay tax-free

[1] A notional account that tracks certain tax-free income received by a private corporation.

The information provided is based on current tax legislation and interpretations for Canadian residents and is accurate to the best of our knowledge as of the date of publication. Future changes to tax legislation and interpretations may affect this information. This information is general in nature, and is not intended to be legal or tax advice. For specific situations, advice should be obtained from the appropriate professional advisors. This information is provided by London Life Insurance Company and is current as of March, 2016.

capital dividends to its Canadian resident shareholders.

The budget proposes to amend these rules so the credit to the CDA is limited to the death benefit less the ACB of the policy, regardless of whether the beneficiary corporation that receives the death benefit is a policyowner or not. This proposal eliminates the potentially aggressive planning opportunity to credit the entire death benefit to the CDA, even if the policy has an ACB, and distributing it as tax-free capital dividends.

A similar amendment will apply to partnerships, so that the increase in the adjusted cost base of the partnership interest is limited to the death benefit less the ACB of the policy. A partner can generally withdraw funds from partnership tax-free to the extent of his or her interest in the partnership. Limiting the amount that can be added to the partnership interest to the death benefit less ACB of the policy means the partnership interest cannot be increased by the ACB of the policy without considering it as taxable income of the partner.

The budget also introduces an information-reporting requirement where a corporation or partnership is not a policyowner but is entitled to receive a death benefit.

These amendments will apply to the death benefit received as a result of a death that occurs after March 21, 2016.

Transfers of life insurance policies

Generally, in an arm's length disposition of a life insurance policy (i.e. a transfer between unrelated people), the policyowner is deemed to have received the FMV of the policy as proceeds of disposition. However, in a non-arm's length transfer, the proceeds of disposition are deemed to be the value of the policy [commonly referred to as cash surrender value (CSV)]. The purchaser's ACB of the policy is deemed to be equal to the CSV of the policy. As a result of this deeming rule, it is possible for a non-arm's length person to transfer a life insurance policy, with a FMV higher than the CSV, to a private corporation or partnership and withdraw the amount equal to the FMV less the CSV of the policy tax-free from the corporation or partnership.

When the private corporation receives the death benefit, the death benefit less the ACB of the policy is credited to its CDA and may be distributed to Canadian resident shareholders as tax-free capital dividends. This will result in shareholders extracting an amount equal to the policy's FMV less the CSV on a tax-free basis twice. Similar results may arise where the policy is transferred as a capital contribution.

The budget proposes to amend the rules so the proceeds of the disposition of the policy in a non-arm's length transfer will be equal to the FMV of the consideration given. This FMV will become the new ACB of the policy to the purchaser. As a result, any consideration received in excess of the CSV of the policy will be included in calculating any policy gain on transfer of the policy. Similarly, if the transfer of the policy resulted in a contribution of capital to a corporation or partnership, the resulting increase in the paid-up capital of the class of shares of the corporation or the interest in a partnership will be limited to the amount of proceeds of disposition (i.e.

the amount used as sales proceeds in calculating the policy gain).

These amendments are proposed to apply to the transfers that occur after March 21, 2016.

Where the transfer of the policy took place before March 22, 2016 for proceeds of disposition higher than CSV of the policy, the budget proposes the amount that will be eligible for addition to the CDA of a private corporation or to the ACB of the partnership interest will be reduced by the excess of proceeds of disposition over the CSV.

In addition, where the policy is transferred before March 22, 2016 as a capital contribution (e.g. purchase consideration for shares), the increase in paid-up capital or an interest in the partnership will be limited to the amount of proceeds of disposition.

These amendments are proposed to apply to policies under which the death benefits are received as a result of the death that occur after March 21, 2016.

Sales of linked notes

A linked note is a debt obligation, the return on which is linked in some manner to the performance of one or more reference assets or indexes over the term of the obligation. The two main types of linked notes are principal-protected notes and principal-at-risk notes. Interest accrued to the date of maturity of a debt obligation is included in the income of the vendor; however, some investors, who hold their linked notes as capital property, sell them prior to the determination date. In effect, they convert the return on the notes from ordinary income to capital gains, only 50 percent of which is included in their income.

Budget 2016 proposes to ensure the return on a linked note retains the same character whether it is earned at maturity or reflected in a secondary market sale, as ordinary income. This measure will apply to all sales after September 2016.

As a result of this proposal, these notes have lost their tax-effective properties and will be taxed at the top marginal tax rate. When considering investment alternatives, these notes will now be earning interest income, which makes them less tax efficient.

Restoring Old Age Security eligibility age

Federal budget 2016 restores the eligibility age for Old Age Security and Guaranteed Income Supplement benefits to 65 and Allowance benefits to 60. This cancels the previous provisions that increased the age of eligibility to 67 and 62, respectively.

Tax credit changes

There are a number of proposed legislation changes that will affect families across Canada.

Canada Child Benefit

The Canadian government currently supports families with children under the age of 18 through the Canada child tax benefit (CCTB) and the universal child care benefit (UCCB), which provide taxable and non-taxable benefits.

The new Canada Child Benefit will replace the CCTB and UCCB, which will provide a maximum, non-taxable benefit of:

- $6,400 per child under the age of 6
- $5,400 per child aged 6 through 17

The benefit will be phased out at the following rates, based on adjusted family net income:

- Between $30,000 and $65,000
  - One-child family 7 per cent
  - Two-child family 13.5 per cent
  - Three-child family 19 per cent
  - Larger families 23 per cent
- Over $65,000
  - One-child family 3.2 per cent
  - Two-child family 5.7 per cent
  - Three-child family 8 per cent
  - Larger families 9.5 per cent

Families with children eligible for the disability tax credit will receive an additional benefit of $2,730 to recognize the increased cost of caring for children with severe disabilities. It will be phased out at the following rates, based on adjusted family income over $65,000 (effective July 1, 2016):

- One eligible child 3.2 per cent
- More than one eligible child 5.7 per cent

Income splitting credit

Federal budget 2016 will eliminate the $50,000 notional transfer of taxable income between spouses and common-law partners with at least one child under the age of 18 starting in 2016. This does not affect pension income splitting.

Children's fitness and arts tax credits

Budget 2016 will phase out both the children's fitness tax credit and the children's art tax credit. The fitness credit is reduced to $500 from $1,000, and the arts tax credit is reduced to $250 from $500 for 2016.

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

Northern residents deduction

Budget 2016 proposes to increase the maximum residency deduction for each member of the household from $8.25 to $11 per day. When no other member household claims the deduction, it will increase from $16.50 to $22. Residents of the Intermediate zone are entitled to claim 50 per cent of the above amounts.

Labour-sponsored venture capital corporations tax credit

Budget 2016 proposes to restore the federal Labour-sponsored venture capital corporations (LSVCC) tax credit to 15 per cent for share purchases of provincially registered LSVCC prescribed under the *Income Tax Act.*

The federal LSVCC tax credit for federally registered LSVCCs will remain at five per cent for 2016 and will be eliminated in 2017 and subsequent taxation years.

Previously announced measures

Capital gains exemption on donation of private corporation shares or real estate

Federal budget 2015 announced an exemption for capital gains tax on certain dispositions of private corporation shares or real estate where the cash proceeds were donated to a registered charity or other qualified donee (recipient) within 30 days. The government announced it will not proceed with this measure that was slated to begin in 2017.

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Tax-deductible inter-corporate dividend

Federal budget 2016 confirms the government's intention to proceed with the amendment to subsection 55(2), which affects tax-deductible inter-corporate dividends. More information is available here.

Small business tax rate and non-eligible dividend

The small business tax rate for qualifying active business income of a Canadian-controlled private corporation up to $500,000 is 10.5 per cent in 2016. This rate was legislated to reduce by 0.5 per cent in each of 2017, 2018 and 2019.

The budget proposes to keep the tax rate at 10.5 per cent after 2016. The gross-up factor for non-eligible dividends (17 per cent) and corresponding factor for the dividend tax credit (21/29 of the gross-up amount) will also be maintained.

Proposed tax changes

A Notice of Ways and Means motion to amend the Income Tax Act was released with an effective date of Jan. 1, 2016. It included changes to the following:

- Personal income tax rate changes
- TFSA dollar limit reduction
- Deduction by individuals for gifts
- Tax on split income
- Tax payable by *inter vivos* trust
- Private corporations (including refundable tax on CCPC's investment income and dividend refund)

Here is more information on the changes.

For full details about the 2016 budget, visit fin.gc.ca.