March 22, 2015

tax & business Alert

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NEW BUDGET HIGHLIGHTS:

- New Canada Child Benefit
- New Rules for Life Insurance Policies

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FEDERAL BUDGET 2016

The Minister of Finance, Bill Morneau, today tabled the new Government of Canada's first federal budget — *Growing the Middle Class* — in the House of Commons. The budget is expected to show a deficit of $29.4 billion in 2016-17, gradually declining to a deficit of $14.3 billion by 2020-2021.

The following is a summary of the tax highlights.

BUSINESSES

SMALL BUSINESS TAX RATE

Budget 2016 proposes that the small business tax rate remains at 10.5 per cent after 2016. In order to preserve the integration of the personal and corporate income tax systems, Budget 2016 also proposes to maintain the current gross-up factor and dividend tax credit (DTC) rate applicable to non-eligible dividends (generally, dividends distributed from corporate income taxed at the small business tax rate).

Specifically, the gross-up factor applicable to non-eligible dividends will be maintained at 17 per cent and the corresponding DTC rate at 21/29 of the gross-up amount. Expressed as a percentage of the grossed-up amount of a non-eligible dividend, the effective rate of the DTC in respect of such a dividend will remain at 10.5 per cent after 2016, in line with the small business tax rate.

MULTIPLICATION OF THE SMALL BUSINESS DEDUCTION

The specified partnership income rules in the Income Tax Act are intended to eliminate the multiplication of the small business deduction in respect of a partnership of corporations that are not associated with each other. In such a case, a single business limit applies with respect to the partnership's business. In the absence of these rules, each Canadian Controlled Private Corporation (CCPC) that is a member of a partnership could claim a separate small business deduction of up to $500,000 in

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INDIVIDUALS

CANADA CHILD BENEFIT

There are currently two main federal instruments for the provision of financial assistance to families with children under age 18: The Canada Child Tax Benefit (CCTB) and the Universal Child Care Benefit (UCCB).

To simplify and consolidate existing child benefits while ensuring that help is better targeted to those who need it most, Budget 2016 proposes to replace the CCTB and UCCB with a new Canada Child Benefit.

The Canada Child Benefit will provide a maximum benefit of $6,400 per child under the age of 6 and $5,400 per child aged 6 through 17. On the portion of adjusted family net income between $30,000 and $65,000, the benefit will be phased out at a rate of 7 per cent for a one-child family, 13.5 per cent for a two child family, 19 per cent for a three-child family and 23 per cent for larger families. Where adjusted family net income exceeds $65,000, remaining benefits will be phased out at rates of 3.2 per cent for a one-child family, 5.7 per cent for a two-child family, 8 per cent for a three-child family and 9.5 per cent for larger families, on the portion of income above $65,000.

To recognize the additional costs of caring for a child with a severe disability, Budget 2016 proposes to continue to provide an additional amount of

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respect of the portion of the partnership's active business income allocated to it.

In general terms, the small business deduction that a CCPC that is a member of a partnership can claim in respect of its income from the partnership is limited to the lesser of the active business income that it receives as a member of the partnership (its "partnership ABI") and its pro-rata share of a notional $500,000 business limit determined at the partnership level (its specified partnership income limit, or "SPI limit"). A CCPC's specified partnership income is added to its active business income from other sources, if any, and the CCPC can claim the small business deduction on the total (subject to its annual business limit).

Some taxpayers have implemented structures to circumvent the application of the specified partnership income rules. In a typical structure, a shareholder of a CCPC is a member of a partnership and the partnership pays the CCPC as an independent contractor under a contract for services. As a result, the CCPC claims a full small business deduction in respect of its active business income earned in respect of the partnership because, although the shareholder of the CCPC is a member of the partnership, the CCPC is not a member.

To address this tax planning, Budget 2016 proposes to extend the specified partnership income rules to partnership structures in which a CCPC provides (directly or indirectly, in any manner whatever) services or property to a partnership during a taxation year of the CCPC where, at any time during the year, the CCPC or a shareholder of the CCPC is a member of the partnership or does not deal at arm's length with a member of the partnership. In general terms, for the purpose of the specified partnership rules:

- a CCPC will be deemed to be a member of a partnership throughout a taxation year if
  - ∗ it is not otherwise a member of the partnership in the taxation year,
  - ∗ it provides services or property to the partnership at any time in the taxation year,
  - ∗ a member of the partnership does not deal at arm's length with the CCPC, or a shareholder of the CCPC, in the taxation year, and
  - ∗ it is not the case that all or substantially all of the CCPC's active business income for the taxation year is from providing services or property to arm's length persons other than the partnership;
- a CCPC that is a member of a partnership (including a deemed member) will have its active business income from providing services or property to the partnership deemed to be partnership ABI; and
- the SPI limit of a deemed member of a partnership will initially be nil (as it does not receive any allocations of income from the partnership). However, an actual member of the partnership who does not deal at arm's length with a deemed member of the partnership will be entitled to notionally assign to the deemed member all of or a portion of the actual member's SPI limit in respect of a fiscal period of the partnership that ends in the deemed member's taxation year (and where the actual partner is an individual, the assignable SPI limit of all members of the partnership will be determined as if they were corporations).

This measure will apply to taxation years that begin on or after Budget Day. However, an actual member of a partnership will be entitled to notionally assign all or a portion of the member's SPI limit in respect of their taxation year that begins before and ends on or after Budget Day.

Tax Free Savings Account

Effective January 1, 2016, the amount of contribution room allocated each year to a qualifying individual will be returned to its original level of $5,000, indexed to inflation for each year after 2009 and rounded to the nearest $500. On this basis, an individual's limit will be $5,500 for 2016.

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Life Insurance Policies

Distributions Involving Life Insurance Proceeds

Life insurance proceeds received as a result of the death of an individual insured under a life insurance policy (a "policy benefit") are generally not subject to income tax. A private corporation may add the amount of a policy benefit it receives to its capital dividend account, which consists of certain non-taxable amounts. A private corporation may elect to pay a dividend as a capital dividend to the extent that the corporation's capital dividend account has a positive balance. Capital dividends are received tax-free by shareholders.

The income tax rules for partnerships also account for a policy benefit being non-taxable. The adjusted cost base of a partner's interest in a partnership is increased to the extent of the partner's share of a policy benefit received by the partnership. A partner can generally withdraw funds from a partnership tax-free to the extent of the partner's adjusted cost base.

In the life insurance context, only the portion of the policy benefit received by the corporation or partnership that is in excess of the policyholder's adjusted cost basis of the policy (the "insurance benefit limit") may be added to the capital dividend account of a corporation or to the adjusted cost base of a partner's interest in a partnership.

Some taxpayers have structured their affairs so that the insurance benefit limit may not apply as intended, resulting in an artificial increase in a corporation's capital dividend account balance. A similar result could be achieved under the rules for computing the adjusted cost base of a partner's interest in a partnership. This planning may allow those taxpayers to avoid income tax on dividends payable by a private corporation or on gains from the disposition of a partnership interest. These results are unintended and erode the tax base.

Although the Government is challenging a number of these structures under the existing tax rules, Budget 2016 proposes to amend the Income Tax Act to ensure that the capital dividend account rules for private corporations, and the adjusted cost base rules for partnership interests, apply as intended. This measure will provide that the insurance benefit limit applies regardless of whether the corporation or partnership that receives the policy benefit is a policyholder of the policy. To that end, the measure will also introduce information-reporting requirements that will apply where a corporation or partnership is not a policyholder but is entitled to receive a policy benefit.

Transfers of Life Insurance Policies

Where a policyholder disposes of an interest in a life insurance policy to an arm's length person, the fair market value of any consideration is included in computing the proceeds of the disposition. In contrast, where a policyholder disposes of such an interest to a non-arm's length person, a special rule (the "policy transfer rule") deems the policyholder's proceeds of the disposition, and the acquiring person's cost, of the interest to be the amount that the policyholder would be entitled to receive if the policy were surrendered (the "interest's surrender value").

Where the policy transfer rule applies, the amount by which any consideration given for the interest exceeds the interest's surrender value is not taxed as income under the rules that apply to dispositions of interests in life insurance policies. In addition, this excess will ultimately be reflected in the policy benefit under that policy. Where the policy benefit is received by a private corporation, it can be paid tax-free to that corporation's shareholders. Where this is the case and consideration to acquire the interest was not recognized under the policy transfer rule, the amount of the excess is effectively extracted from the private corporation a second time as a tax-free, rather than as a taxable, amount. These results are unintended and erode the tax base. Similar concerns also arise in the partnership context and where an interest in a policy is contributed to a corporation as capital.

Budget 2016 proposes amendments to the Income Tax Act to ensure that amounts are not inappropriately received tax-free by a policyholder as a result of a disposition of an interest in a life insurance policy. The measure will, in applying the policy transfer rule, include the fair market value of any consideration given for an interest in a life insurance policy in the policyholder's proceeds of the disposition and the acquiring person's cost. In addition, where the disposition arises on a contribution of capital to a corporation or partnership, any resulting increase in the paid-up capital in respect of a class of shares of the corporation, and the adjusted cost base of the shares or of an interest in the partnership, will be limited to the amount of the proceeds of the disposition.

This measure will apply to dispositions that occur on or after Budget Day. Budget 2016 also proposes to amend the capital dividend account rules for private corporations and the adjusted cost base rules for partnership interests. This amendment will apply where an interest in a life insurance policy was disposed of before Budget Day for consideration in excess of the proceeds of the disposition determined under the policy transfer rule. In this case, the amount of the policy benefit otherwise permitted to be added to a corporation's capital dividend account, or the adjusted cost base of an interest in a partnership, will be reduced by the amount of the excess. In addition, where an interest in a life insurance policy was disposed of before Budget Day under the policy transfer rule to a corporation or partnership as a contribution of capital, any increase in the paid-up capital in respect of a class of shares of the corporation, and the adjusted cost base of the shares or of an interest in the partnership, that may otherwise have been permitted will be limited to the amount of the proceeds of the disposition.

These measures will apply in respect of policies under which policy benefits are received as a result of deaths that occur on or after Budget Day.

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up to $2,730 per child eligible for the disability tax credit. The phase-out of this additional amount will be made to generally align with the Canada Child Benefit. Specifically, it will be phased out at a rate of 3.2 per cent for families with one eligible child and 5.7 per cent for families with more than one eligible child, on adjusted family net income in excess of $65,000, effective July 1, 2016. This additional amount will be included in the Canada Child Benefit payments made to eligible families. Entitlement to the Canada Child Benefit for the July 2016 to June 2017 benefit year will be based on adjusted family net income for the 2015 taxation year.

Canada Child Benefit payments under this measure will start in July 2016. The UCCB and CCTB will be eliminated for months after June 2016.

Income Splitting Credit

A non-refundable income splitting tax credit is available for couples with at least one child under the age of 18. The credit allows a higher-income spouse or common-law partner to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner for the purpose of reducing the couple's total income tax liability by up to $2,000.

Budget 2016 proposes to eliminate the income splitting tax credit for couples with at least one child under the age of 18 for the 2016 and subsequent taxation years.

Teacher and Early Childhood Educator School Supply Tax Credit

Teachers and early childhood educators often incur at their own expense the cost of supplies for the purpose of teaching students in the classroom or learning environment.

Budget 2016 proposes to introduce a teacher and early childhood educator school supply tax credit. This measure will allow an employee who is an eligible educator to claim a 15-per-cent refundable tax credit based on an amount of up to $1,000 in expenditures made by the employee in a taxation year for eligible supplies.

For the cost of supplies to qualify for the credit, 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. Individuals making claims will be required to retain their receipts for verification purposes.

The teacher and early childhood educator school supply tax credit will not be available in respect of an amount that has already been claimed under any other provision of the Income Tax Act.

This measure will apply to supplies acquired on or after January 1, 2016.

Mineral Exploration Tax Credit for Flow-Through Share Investors

Flow-through shares allow resource companies to renounce or "flow through" tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income. The mineral exploration tax credit provides an additional income tax benefit for individuals who invest in mining flow-through shares. This credit is equal to 15 per cent of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors. Like flow-through shares, the credit facilitates the raising of equity to fund exploration by enabling companies to issue shares at a premium.

Budget 2016 proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2017.

Education and Textbook Tax Credits

The education tax credit provides a 15-per-cent non-refundable tax credit of $400 per month of full-time enrolment in a qualifying educational program and $120 per month of part-time enrolment in a specified educational program at a designated educational institution. The textbook tax credit provides a 15-percent non-refundable tax credit of $65 per month of full-time enrolment in a qualifying educational program and $20 per month of part-time enrolment in a specified educational program at a designated educational institution.

A tuition tax credit is also available that provides a 15-per-cent non-refundable tax credit on eligible fees for tuition and eligible examination fees paid to certain educational institutions.

A student must first claim any education, textbook and tuition credits earned in a year on their own tax return to bring tax payable to zero. Unused portions of the credits can be transferred to a supporting individual, up to a limit, or carried forward by the student for use in a future year.

Budget 2016 proposes to eliminate the education and textbook tax credits. This measure does not eliminate the tuition tax credit. Changes will be made to ensure that other income tax provisions—such as the tax exemption for scholarship, fellowship and bursary income—that currently rely on eligibility for the education tax credit or use terms defined for the purpose of the education tax credit will be unaffected by its elimination.

This measure will apply effective January 1, 2017. Unused education and textbook credit amounts carried forward from years prior to 2017 will remain available to be claimed in 2017 and subsequent years.

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Readers are reminded that while budget proposals are customarily given the effect of law immediately, the amending legislation, when ultimately adopted by Parliament, may be altered to some degree.

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CHILDREN'S FITNESS AND ARTS TAX CREDITS

The children's fitness tax credit provides a 15-per-cent refundable tax credit on up to $1,000 of eligible fitness expenses for children under 16 years of age at the beginning of the taxation year. For children who are eligible for the disability tax credit and have at least $100 of eligible expenses, the credit amount is increased by $500 and is extended to children under 18 years of age.

The children's arts tax credit provides a 15-per-cent 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. As with the children's fitness tax credit, the age limit of the children's arts tax credit is extended to children under 18 years of age and an additional $500 credit amount is available in respect of children eligible for the disability tax credit.

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 (which will remain refundable for 2016) and to $250 from $500 for the children's arts tax credit. The supplemental amounts for children eligible for the disability tax credit will remain at $500 for 2016. Both credits will be eliminated for the 2017 and subsequent taxation years.

TOP MARGINAL INCOME TAX RATE CONSEQUENTIAL AMENDMENTS

On December 7, 2015, the Government announced a reduction of the second personal income tax rate to 20.5 per cent from 22 per cent and the introduction of a 33-per-cent personal income tax rate on individual taxable income in excess of $200,000, effective for the 2016 and subsequent taxation years. (See Levi & Levi's *"Federal Tax Rate Changes for 2016"* newsletter on our website for more information.)

A number of amendments were included that were consequential to the introduction of the new 33-per-cent top personal income tax rate. The Income Tax Act contains a series of rules that are intended to maintain the neutrality, fairness and integrity of the income tax system. A number of these rules either use the top personal income tax rate or use rates or formulas that reflect it. The consequential amendments that were announced adjust a number of the most significant of these rules. The Government also announced that it would review other income tax rules to determine whether they require adjustment.

Budget 2016 proposes further amendments to reflect the new top marginal income tax rate for individuals that will:

- provide a 33-per-cent charitable donation tax credit (on donations above $200) to trusts that are subject to the 33-per-cent rate on all of their taxable income;
- apply the new 33-per-cent top rate on excess employee profit sharing plan contributions;
- increase from 28 per cent to 33 per cent the tax rate on personal services business income earned by corporations;
- amend the definition of "relevant tax factor" in the foreign affiliate rules to reduce the relevant tax factor from the current 2.2 to 1.9;
- amend the capital gains refund mechanism for mutual fund trusts to reflect the new 33-per-cent top rate in the formulas that are used in computing refundable tax;
- increase the Part XII.2 tax rate on the distributed income of certain trusts from 36 per cent to 40 per cent; and
- amend the recovery tax rule for qualified disability trusts to refer to the new 33-per-cent top rate.

These measures will apply to the 2016 and later taxation years. The charitable donation tax credit measure will be limited to donations made after the 2015 taxation year. In the case of the rate increase on personal services business income earned by corporations in taxation years that straddle 2015 and 2016, the rate increase will be prorated according to the number of days in the taxation year that are after 2015.

The measure will also extend the proposed 33-per-cent charitable donation tax credit (which currently applies to donations made after 2015) to be available for donations made by a graduated rate estate during a taxation year of the estate that straddles 2015 and 2016.

STATUS OF OUTSTANDING TAX MEASURES

A number of tax measures that were originally proposed in previous budgets or during the last Parliament were not legislated before Parliament was dissolved as a result of the election call. Most of these measures would close tax loopholes and improve the integrity of the tax system, relieve taxpayers of certain tax consequences or improve the administration of the tax system.

Budget 2016 confirms the Government's intention to proceed with tax and related measures, as modified, to take into account consultations and deliberations since their announcement or release, relating to:

- "synthetic equity arrangements" under the dividend rental arrangement rules;
- the conversion of capital gains into tax-deductible inter-corporate dividends (section 55);
- the offshore reinsurance of Canadian risks;
- alternative arguments in support of an assessment;
- an exception to the withholding tax requirements for payments by qualifying non-resident employers to qualifying non-resident employees;
- the repeated failure to report income penalty;
- the acquisition or holding of limited partnership interests by registered charities;
- the qualification of certain costs associated with undertaking environmental studies and community consultations as Canadian exploration expenses;
- the sharing of taxpayer information within the Canada Revenue Agency to facilitate the collection of certain non-tax debts;
- the sharing of taxpayer information with the Office of the Chief Actuary;
- the tax deferral in respect of the commercialization of the Canadian Wheat Board;
- the Goods and Services Tax/Harmonized Sales Tax joint venture election; and
- the relief of the Goods and Services Tax/Harmonized Sales Tax for feminine hygiene products.

Budget 2016 also announces the Government's intention not to proceed with the measure announced in Budget 2015 that would provide an exemption from capital gains tax for certain dispositions of private corporation shares or real estate where cash proceeds from the disposition are donated to a registered charity or other qualified donee within 30 days.

ALERT DATES

April 30, 2016	Deadline for filing personal income tax returns other than those permitted to file by June 15.
June 15, 2016	Second installment due for individuals required to make income tax installments.
	Filing date for individuals reporting business income including professional income and their spouses
September 15, 2016	Third installment due for individuals required to make income tax installments.
December 15, 2016	Fourth installment due for individuals required to make income tax installments.

ABOUT LEVI & LEVI

LEVI & LEVI is a firm of chartered professional accountants that traces its origin in Montreal to 1970. We pride ourselves on being more than just an accounting firm. We offer an effective blend of personalized service, experience and technological leadership, coupled with a steadfast commitment to consistently deliver excellence. Our Chartered Professional Accountants and Business Consultants provide advisory services on a broad range of issues to both our individual and corporate clients. The members of our firm possess unique talents, expertise and experience, giving our clients access to a knowledge base of considerable breadth and depth. Together with our support personnel, we share a commitment to developing practical solutions for the business challenges of today, and to devising strategies for tomorrow.

OUR SERVICES

LEVI & LEVI takes pride in adding value to every client that we serve through our extensive expertise and proactive approach to your financial needs. We match our dedication to adding value with experience and expertise: we have experience in servicing virtually every type of industry and professional practice.

TAXATION

LEVI & LEVI has a strong basis in federal and provincial tax issues. Our tax group is highly qualified and experienced. Our accountants work hard to minimize your taxes, yet make sure that you fulfill your tax requirements ethically while working to add value. We can fill a variety of tax needs, both domestic and international as well as corporate and personal. Our specialties lie in tax reporting and representation, tax planning (business, personal, divorce and litigation), tax structuring of entities and transactions and tax research.

FINANCIAL

LEVI & LEVI can meet all of your basic financial needs with our exemplary Accounting Services Group that can truly add value whether it's your business or your personal finances that we are reviewing. We work with business entities as well as non-profits and foundations. Our accounting services include; auditing and compilation review of financial statements, budgets and forecasts, and government reporting. We won't simply process your financial statements, our mission is to add value. We will go the extra mile to help you forecast or locate opportunities that you may be missing.

BUSINESS CONSULTING

LEVI & LEVI's Business Consulting unit has proven itself as a valuable resource to businesses of all kinds. We can help you plan your future, whether you see it coming or not. We can help you bring seminal business events to life; like mergers and acquisitions, business valuation, leases and contracts, or business development plans, all of which take a huge amount of planning and attention to detail. If there are no big events on your horizon, we can still be of service by helping you to anticipate the unexpected through our forecasting, real estate projections, risk management assessments, or our feasibility studies. We look at your business and all of its many facets, to find both issues and opportunities and bring that valuable insight to you.

Litigation Support and Dispute Resolution Service Areas

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- **Fairness opinions**
- **Insurance claim assistance**
- **Retail sales audits**
- **Contract dispute resolution**
- **Professional negligence litigation support**
- **Fraud prevention program design, implementation and evaluation**
- **Bank due diligence audits**
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- **Divorce litigation support**
- **Insurance claim quantification**
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- **Electronic Discovery and Data Recovery**
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