FEDERAL BUDGET 2017: BUSINESS TAX MEASURES

The 2017-18 federal Budget, brought down on March 22, 2017 by Minister of Finance Bill Morneau, contained a number of business-related tax measures; however, those measures were generally targeted in nature, affecting specific industries or taxpayer groups. Most of the measures announced will eliminate existing tax preferences or exemptions, but there were no changes to business tax rates, and no other business tax changes which were of general application.

Wolters Kluwer

Measures affecting professionals

Elimination of the work-in-progress rule

General tax rules require that taxpayers, when calculating income for a tax year, include the value of work in progress. However, some designated professions, including accountants, dentists, lawyers, doctors, veterinarians, and chiropractors, have benefitted from an exception which allows them to choose to exclude the value of work in progress when computing income for the year.

That exception has provided a tax benefit to the affected groups as they were able, for current year tax purposes, to deduct expenses associated with the work in progress without being required to include the income from that work in progress. Such income would only need to be included in income for tax purposes when it was billed for.

The Budget proposes to eliminate the exception allowing designated professionals to elect to exclude work in progress, effective for taxation years ending after March 22, 2017.

The repeal of that exception will be implemented on a transitional basis. The transitional rules provide that for the first taxation year that begins on or after the Budget date of March 22, 2017, one-half of the cost and the fair market value (FMV) of work in progress, whichever is less, will be taken into account for the purposes of determining the value of the inventory held by the business. For the second and each successive taxation year that begins after the Budget date, the full amount of the lesser of those two amounts will be taken into account for the purpose of valuing inventory.

Measures affecting the energy sector

Changes to CCA system for energy efficient equipment

Under the capital cost allowance (CCA) system, Canadian taxpayers are permitted to claim a deduction to recognize the depreciation in the value of assets which they own, with the percentage rate of depreciation based on the useful life of the assets included in a particular asset class. In some cases, accelerated CCA is allowed, providing a financial benefit to the taxpayer. Such accelerated CCA is permitted with respect to clean energy generation equipment, and the Budget proposes to expand the kinds of assets eligible for such accelerated CCA.

Classes 43.1 and 43.2 provide accelerated CCA at rates of 30% and 50%, respectively, for investments made in clean energy generation and conservation equipment. Generally, such equipment generates or conserves energy by using a renewable energy source or fuel from waste, or makes efficient use of fossil fuels.

Measures announced in the Budget propose that the list of geothermal energy equipment which is included in 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. As well, geothermal heating will be made an eligible thermal energy source for use in a district energy system, and will therefore qualify for accelerated CCA treatment. Finally, expenses incurred in order to determine the extent and quality of a geothermal resource and the cost of geothermal drilling will qualify as a Canadian renewable and conservation resource, which may be fully deducted in the year they are incurred.

The Budget Papers specify that accelerated CCA treatment and renewable and conservation resource treatment will be made available only for those acquisitions and projects that, at the time they are first available for use, fulfill the requirements of all applicable environmental laws, by-laws and regulations.

Changes to Canadian exploration expense rules

The Budget proposes a change in the tax treatment of expenses associated with drilling an oil or gas well that results in the discovery of a previously unknown petroleum or natural gas reservoir – known as a "discovery well". Under current rules, such expenditures are treated as Canadian exploration expenses (CEE), which are fully deductible in the year they are incurred. Similar expenditures related to drilling of wells which are not discovery wells are treated as Canadian development expenses (CDE), which can be deducted at a rate of 30% per year.

The federal government has concluded that, in order to ensure more appropriate matching, expenditures related to drilling or completing discovery wells should be treated as CDE instead of CEE. Where, however, a well is abandoned, has not produced within 24 months, or is certified by the Minister of National Revenue, drilling expenditures can be classified or reclassified as CEE.

The change will be effective for expenses incurred after 2018. However, where a taxpayer has, prior to March 22, 2017, entered into a written commitment to incur such expenses, the change will not apply to those expenses incurred prior to 2021.

Changes to flow-through share rules

Under current rules, small Canadian oil and gas corporations (defined for this purpose as those with taxable capital employed in Canada of less than $15 million) can treat up to $1 million of CDEs as CEEs, when renouncing those expenditures to flow-through shareholders.

The federal Budget proposes to eliminate that rule, with the change generally effective for expenditures incurred after 2018.

Measures affecting investors

Tax treatment of derivatives

Currently, the *Income Tax Act* does not contain any rules of general application which govern the timing of the recognition of gains and losses on derivative instruments which are held on income account. The Budget proposes two new such rules.

The first proposed change will introduce an elective mark-to-market regime for derivatives held on income account. That election will permit taxpayers to mark to market all of their eligible derivatives and, once such election is made, it will remain effective for all subsequent taxation years. The election may be revoked only with the consent of the Minister of National Revenue.

The second proposed change will affect the tax treatment of straddle transactions using derivatives. Generally, straddle transactions involve a taxpayer concurrently entering into two or more positions that are expected to generate equal and offsetting gains and losses. The loss transaction is disposed of before the taxpayer's year end, allowing the taxpayer to claim the loss for that year, but the disposition of the gain transaction, as well as the recognition for tax purposes of the gain realized, is deferred until after year end. The federal government has challenged such transactions in the Courts, and now proposes a new anti-avoidance rule to apply to straddle transactions involving derivatives. The new provision 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. The new stop-loss rule will be subject to a number of exceptions, and will be effective for any loss realized on a position entered into on or after March 22, 2017.

Investment fund mergers

Current tax rules allow the reorganization of certain investment funds on a tax-deferred basis, but those rules apply in a limited number of circumstances.

The Budget proposes to expand the application of such current rules to facilitate the tax-deferred reorganization of a mutual fund corporation from a switch corporation (generally, a corporation with multiple classes of shares, each class typically representing a single investment fund) into multiple mutual fund trusts (effective for qualifying reorganizations that occur on or after March 22, 2017) and to allow insurers to effect tax-deferred mergers of segregated funds (effective for mergers carried out after 2017). In addition, segregated funds will, effective for non-capital losses incurred in taxation years that begin after 2017, be able to carry over such losses and apply them in computing their taxable income for taxation years beginning after 2017.

Measures affecting the insurance industry

Insurers of farming and fishing property

Insurance companies which insure property used in farming and fishing (include residences of individuals engaged in such work) currently benefit from a tax exemption which is based on the proportion of their gross premium income (and that of their affiliated insurers) earned from insuring such property. As well, prescribed insurers are provided preferential access to that tax exemption in that they are not required to take into account gross premium income of affiliated insurers when determining their eligibility for the tax exemption.

The Budget proposes to eliminate the tax exemption for insurers of farming and fishing property, effective for taxation years that begin after 2018.

Other measures

Investment tax credit for child care spaces eliminated

Under pre-Budget rules, a 25% non-refundable credit was available in respect of costs incurred to build or expand child care spaces in licensed child care facilities for the benefit of children of the taxpayer's employees. The maximum value of the credit was $10,000 per space created and such credits, where not used in the current tax year, could be carried back three years and forward 20 years.

The Budget proposes to eliminate the investment tax credit for child care spaces, effective for expenditures made on or after March 22, 2017. However, where a written agreement to make such investment was entered into before that date, the credit will continue to be available for eligible expenditures incurred before 2020.

Additional deduction for gifts of medicine eliminated

Where a corporation makes a gift to a registered charity, the amount of that gift is deductible (within limits) by the corporation in calculating its taxable income for the year. Corporations which donate medicine from their inventories to an eligible charity are entitled to claim an additional deduction, which is equal to the lesser of the following two amounts:

- the cost of the donated medicine; or
- 50% of the amount by which the value of that medicine exceeds its cost.

The Budget proposes to eliminate the additional deduction provided to corporations for donations of medicine, effective for such gifts made on or after March 22, 2017. This change does not affect the general income tax treatment of donations made by corporations to registered charities, including donations of medicine.

More detailed information on each of the measures outlined above can be found in the 2017 Federal Budget papers, which are available on the Finance Canada website at www.budget.gc.ca/2017/home-accueil-en.html.