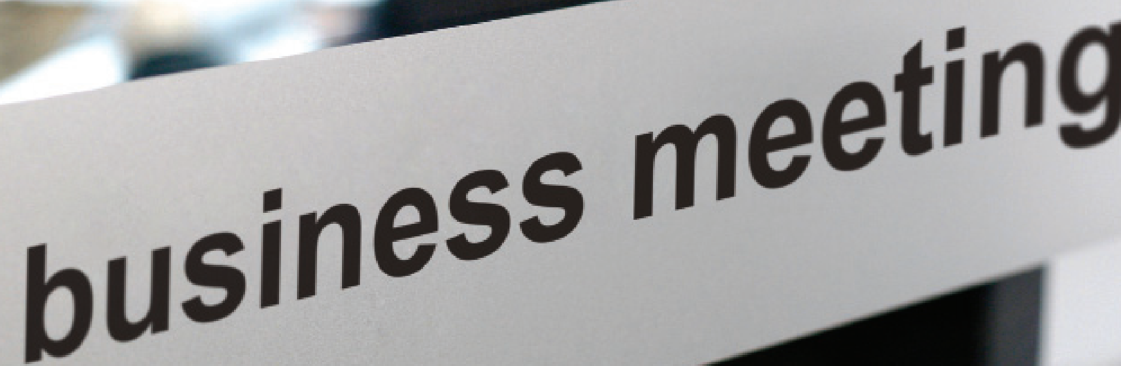

FEDERAL BUDGET 2016: TAX CHANGES FOR BUSINESS

The 2016 federal Budget brought down on Tuesday March 22, 2016 contained relatively few broad-based measures affecting Canadian businesses, as most of the changes announced were of a technical nature. Many of the measures brought forward dealt with the tax treatment of alternative energy sources and energy conservation, and a number of anti-avoidance measures intended to address perceived abuses of the existing small business tax regime were also announced.

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Measures affecting small business

Small business tax rate

Rules currently in place call for the reduction of the small business tax rate in 2017, 2018, and 2019. However, Budget 2016 proposes that the small business rate remain at the current rate of 10.5% after 2016. As well, the current gross-up and dividend tax credit rates on dividends paid out of income subject to that small business rate will be maintained.

Anti-avoidance rules for the small business deduction

Canada's small business tax regime allows small businesses to benefit from a reduced federal corporate income tax rate on the first $500,000 of eligible business income. That regime also includes rules intended to prevent unintended use of the small business deduction through partnership and corporate structures that multiply access to that deduction. The 2016 federal Budget includes new anti-avoidance rules to prevent perceived abuses in this area.

Anti-avoidance rule for associated corporations

Under existing rules, the $500,000 small business annual limit must be shared among associated corporations, and technical rules exist to determine when corporations are deemed to be associated with one another. The federal government is, however, concerned that structures are being put in place which effectively circumvent those rules. While such structures are being challenged under rules already in place, such challenges are time-consuming and costly. Consequently, the Budget proposes the implementation of a new, specific anti-avoidance rule which will apply to taxation years that begin on or after March 22, 2016.

Review of small business tax regime

In the 2015 federal Budget, it was announced that a review would be carried out of the current small business tax regime and, in particular, the issue of when income of a business which is created to earn income from property should qualify as active business income eligible for the small business deduction. In this year's Budget, the government announced that such review was complete and that no changes or amendments were being proposed at this time.

Measures affecting alternative energy

Changes to capital cost allowance system

The capital cost allowance system generally assigns depreciation rates for property and equipment based on the useful life of the particular asset. Classes 43.1 and 43.2 are an exception to that rule, as accelerated depreciation rates (30% and 50%, respectively) are provided for investments in specified clean energy generation and conservation equipment.

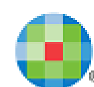
The Budget proposes to expand the types of equipment eligible for inclusion in Classes 43.1 and 43.2. Electric vehicle charging stations will be eligible for inclusion in Class 43.1 or 43.2, depending on whether they meet certain power thresholds. Electric vehicle charging stations set up to supply at least 90 kilowatts of continuous power will be eligible for inclusion in Class 43.2. Those charging stations set up to supply more than 10 kilowatts but less than 90 kilowatts of continuous power will be eligible for inclusion in Class 43.1. The change will be effective for property acquired for use on or after March 22, 2016.

Currently, only limited kinds of electrical energy storage equipment are eligible for accelerated depreciation, when such equipment is ancillary to electrical generation technologies eligible for inclusion in Class 43.1 or 43.2. Budget 2016 proposes two changes in this area. First, it proposes to clarify and expand the range of electrical energy storage property that is eligible for accelerated CCA on the basis that it is ancillary to eligible generation equipment, to include a broad range of short- and long-term storage equipment. If the storage equipment is part of an electricity generation system that is eligible for Class 43.2, it will be included in that Class. Similarly, if the storage equipment is part of an electricity generation system that is eligible for Class 43.1, it will be included in Class 43.1. Second, the Budget proposes that stand-alone electrical energy storage property can be included in Class 43.1, provided that the round trip efficiency of the equipment is greater than 50%. The round trip efficiency measures the extent to which energy is maintained in the process of converting electricity into another form of energy and then back into electricity. Both such measures will be effective for property acquired on or after March 22, 2016.

Taxation of emissions trading regimes

Under emissions trading regimes, governments impose an obligation on regulated emitters to deliver emissions allowances to the government. The amount of the allowances required to be delivered is determined by reference to the amount of emissions of a regulated substance (e.g., greenhouse gases) that are produced. These allowances may be purchased by emitters in the market or at auction, earned in relation to emissions reduction activities or provided by the government at a reduced price or no cost.

To date, no specific tax rules have been put in place to govern the tax treatment of transactions under emissions trading regimes, and such tax treatment is currently determined under general tax principles. This has led to concerns from stakeholders as to uncertainty about the tax treatment of such transactions and about the possibility of double taxation. The 2016 Budget proposes to amend the *Income Tax Act* to introduce such specific rules to clarify the treatment of emissions allowances and to eliminate the possibility of double taxation. Specifically, these rules will provide that emissions allowances be treated as inventory for all taxpayers. However, the



"lower of cost and market" method for the valuation of inventory will not be available for emissions allowances because of the potential volatility in their value.

As outlined in the Budget Papers, if a regulated emitter receives a free allowance, there will be no income inclusion on receipt of the allowance. In addition, the deduction in respect of an accrued emissions obligation will be limited to the extent that the obligation exceeds the cost of any emissions allowances that the taxpayer has acquired and that can be used to settle the obligation. Each year that a taxpayer claims a deduction in respect of an emissions obligation, the taxpayer will quantify its deduction based on the cost of emission allowances that it has acquired and which can be used to settle its emissions obligation, plus the fair market value of any emissions allowances that it still needs to obtain to fully satisfy its obligation. If a deduction is claimed in respect of an emissions obligation that accrues in one year (e.g., 2017) and that will be satisfied in a future year (e.g., 2018), the amount of this deduction will be brought back into income in the subsequent year (2018) and the taxpayer will be required to evaluate the deductible obligation again each year, until it is ultimately satisfied.

If a taxpayer disposes of an emissions allowance other than in satisfaction of an obligation under the emissions allowance regime, any net proceeds received will be included in the taxpayer's income.

This measure will apply generally to emissions allowances acquired in taxation years beginning after 2016, with some application on an elective basis to emissions allowances acquired in taxation years ending after 2012.

Measures affecting eligible capital property/capital cost allowance system

In 2014, the federal government announced that a consultation process would be carried out with respect to the treatment of eligible capital property (ECP) within the existing capital cost allowance (CCA) system. Eligible capital property generally consists of rights or benefits of an intangible nature. Under the existing ECP regime, 75% of an eligible capital expenditure was included in a pool and was deductible at a rate of 7% per year, on a declining balance basis. Concerns had been expressed that the ECP system had become overly complex, and the government intends that the proposal contained in Budget 2016 will simplify the tax compliance burden for affected taxpayers.

Budget 2016 proposes to repeal the existing ECP regime and to replace it with a new CCA class available to businesses. Under the new system, qualifying expenditures will be included in that new CCA class at a 100% inclusion rate. The new class will have a 5% annual depreciation rate, subject to transitional rules.

The new proposal calls for existing pool balances to be calculated and transferred to the new CCA class as of January 1. 2017. The opening balance of the new CCA class for a business will be equal to the business's existing balance as of that date. Finally, for the first 10 years, the depreciation rate for the new CCA class will be 7% on expenditures incurred before January 1, 2017.

Many of the Budget proposals affecting businesses are quite technical, and this summary is general in nature. Those wishing to obtain more information about the technical details of the proposals should consult the 2016 federal Budget papers, which can be found on the Finance Canada website at www.budget.gc.ca/2016/docs/tm-mf/si-rs-en.html.