Finance Minister Bill Morneau will deliver the Liberal government’s 2017 federal budget soon. Although the specific details of the budget are usually developed behind closed doors, there are some clues about the direction the upcoming budget may take. This year, the government’s budget should address the economic challenges of the current environment, including large deficits, and may include measures contemplated in a pre-budget report prepared by the House of Commons Standing Committee on Finance and presented to Parliament on December 7, 2016. This year’s report seems to focus on innovation and contains about a dozen recommendations related to possible tax changes, including measures affecting inter-generational transfers of businesses, research and development (R&D) initiatives, and the creation of a type of patent box program.

In its report, the Committee also recommends that the government work within a fiscal framework that ensures a stable or declining debt-to-gross domestic product ratio, and that it undertake a comprehensive review of the Income Tax Act in consideration of simplifying the tax rules.

The government may also introduce measures based on the outcomes of the tax-based expenditure review it is conducting. Although the government has not publicly announced the results of its review of personal and corporate tax expenditures, the media and other commentators have speculated that the government could increase the capital gains inclusion rates, given that the current 50% capital gains inclusion rate for personal and business taxpayers costs the government more than $12 billion in revenue. In addition, the media has reported that the government is considering a so-called “Netflix tax” that would impose sales tax for digital services that Canadians purchase from foreign-based firms over the internet.
The government may also look to its unfilled election promises from 2015 when considering new measures. On the international front, the government may move forward with some of the OECD’s BEPS initiatives, including possibly adopting the multilateral instrument to facilitate treaty changes.

Another factor to consider is expected U.S. tax reform and lower tax rates under a Trump/Republican-controlled Congress. The budget will likely be developed with an eye towards maintaining Canada’s competitive position (see TaxNewsFlash-Canada 2017-02, “U.S. Primed for Tax Reform Changes”).

**Business tax changes**

*Innovation and patents*

To support research and development efforts, the Committee recommends in its pre-budget report that the government create a first patent program to subsidize the expenses incurred by small and medium-sized businesses obtaining a first patent. In the Committee’s view, this program should be similar to a recent program launched in Quebec.

**KPMG observations — Quebec patent box legislation**

Quebec introduced patent box legislation to support innovation in Quebec’s manufacturing sector in its 2016 provincial budget. The new tax measure, the first of its kind in Canada, provides a deduction to a qualifying innovative manufacturing corporation, for a taxation year equal to a portion of the value of a qualified patented feature that is integrated into qualified property that it sells or rents for the year. The legislation is intended to encourage companies to develop the results of R&D work carried out in Quebec that led to the granting of a patent.

In the pre-budget report, the Committee also acknowledges submissions from Canadian trade and economic groups that call on the government to:
• Create a "patent box" regime that would tax income generated by intellectual property developed in Canada at a lower rate than other intellectual property income

• Integrate businesses and institutions that focus on the commercial application of intellectual property into innovation ecosystems

• Ensure the federal innovation agenda supports pre-existing programs or partnerships (e.g., Manitoba’s Enterprise Machine Intelligence and Learning Initiative).

**R&D initiatives**

The Committee report includes several recommendations intended to support R&D activities in Canada. Specifically, the Committee recommends that the government:

• Support the establishment of a Canadian centre for international research partnerships dedicated to building multi-sectoral, multi-national research programs focused on late-stage technology development

• Consider establishing an automotive R&D centre within the National Research Council of Canada

• Establish targets for investments in discovery research, and develop a long-term strategy for achieving these targets

• Commit to a multi-year increase in direct federal investments in applied research at colleges and institutes

• Establish a small cluster coordinating office and develop tools to collect and share data about the performance of globally competitive innovation clusters

• Work with stakeholders to promote integration of innovative Canadian companies into high-value global supply chains.

**Tax depreciation**

The Committee recommends that the government review and alter capital cost allowance (CCA) rates to reflect changes in technology and the useful life of assets.

The Committee’s report also acknowledges industry submissions on changes to the CCA rate from several different sectors, including telecommunications. These telecommunications submissions call on the government to:

• Standardize and increase the CCA rates for information and communications technology assets
• Standardize and increase the CCA rates for all new expenditures incurred by Internet service providers and cellular carriers serving rural or remote regions

• Increase the CCA rate for depreciable telecommunications assets.

Small business deduction — Campgrounds and storage facilities

The Committee recommends that, for the purpose of determining eligibility for the small business deduction, the income earned by campgrounds and storage facilities should be considered active business income. Previously, the 2015 federal budget noted concerns about how the current rules applied to this income.

Venture capital

In order to support expanding businesses, the Committee recommends that the government invest in a nationally coordinated network supporting “angel investment”, and collect and report data concerning angel investment-related outcomes at the national level. Generally, an angel investment is capital for a business start-up provided by an investor in exchange for convertible debt or ownership equity. The report also acknowledges industry submissions that discuss other ways to support these businesses, including regional development agencies, entrepreneurs, clusters and incubators, and access to financing.

Mining industry

The Committee recommends a review of recent legislative changes to:

• The Atlantic Investment Tax Credit

• The Corporate Mineral Exploration and Development Tax Credit

• Accelerated CCA rates

• The Canadian Exploration Expense and the Canadian Development Expense.

Personal tax changes

Inter-generational transfers of business

The Committee recommends that the government conduct an exhaustive review of the tax treatment of inter-generational transfers of businesses. The Committee notes that, when contemplating succession planning, businesses should be able to consider as many options as possible for transferring their business.

Disability tax credit

In its report, the Committee also recommends that the government review the effectiveness of the disability tax credit and consider making it refundable. In addition, the Committee
says that all activities related to insulin administration should be eligible for the disability tax credit.

Other measures

Some personal tax measures in the 2015 Liberal platform that were not included in the 2016 federal budget could be included in this year’s budget. Specifically, the Liberal government has not yet fulfilled its promises to:

- Provide a 12-month break on EI premiums for employers that employ people between the ages of 18 and 24 who are hired in permanent positions in 2016, 2017 or 2018
- Allow the use of the Home Buyers Plan in situations involving “sudden and significant life changes” such as job relocation or marital breakdown.

Tax expenditures

In preparing the 2017 federal budget, Finance may also consider the results of a comprehensive review of federal tax expenditures that it formally announced on June 17, 2016. This review was originally signaled in the Liberal 2015 election platform, which promised:

an overdue and wide-ranging review of the over $100 billion in increasingly complex tax expenditures that now exist, with the core objective being to look for opportunities to reduce tax benefits that unfairly help those with individual incomes in excess of $200,000 per year.

As part of its review, Finance engaged a panel of external experts for advice, who will most likely consider the 2016 Annual Report on Federal Tax Expenditures as a reference point. This report covers tax credits and a wide range of other targeted tax measures such as preferential tax rates, exemptions, deductions and deferrals that are aimed at reducing taxation for specific groups or to achieve certain public policy objectives. These measures are often considered a form of government spending because they reduce the tax revenue the government would otherwise receive. For example, the current 50% capital gains inclusion rate for personal and business taxpayers costs the government more than $12 billion in revenue combined, according to the report.

It is possible that Finance’s review will focus on some of the more costly personal and corporate tax expenditures. Although pension plans and RRSPs are probably unlikely to be targeted, other large expenditures may be addressed by forthcoming measures in the 2017 federal budget. As determined by the report, the highest-cost tax expenditures, affecting individual taxpayers include:

<table>
<thead>
<tr>
<th>Personal tax expenditure</th>
<th>Estimated cost for 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</table>
Registered Pension Plan deductions $25.7 billion
RRSP deductions $15.5 billion
Partial (i.e., 50%) inclusion of capital gains $5.8 billion
Principal residence exemption $5.3 billion
Dividend gross-up and tax credit $4.6 billion
GST/HST credit $4.4 billion
GST zero-rating of basic groceries $4.3 billion
Age credit $3.3 billion
Charitable donation tax credit $2.9 billion
Non-taxation of benefits from private health and dental plans $2.7 billion
Canada employment tax credit $2.3 billion

As determined by the report, the costliest tax expenditures that benefit business taxpayers include:

<table>
<thead>
<tr>
<th>Corporate tax expenditure</th>
<th>Estimated cost for 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-capital loss carryovers</td>
<td>$8.4 billion</td>
</tr>
<tr>
<td>Partial inclusion of capital gains</td>
<td>$6.3 billion</td>
</tr>
<tr>
<td>Small business deduction</td>
<td>$3.6 billion</td>
</tr>
<tr>
<td>Non-refundable SR&amp;ED tax credits</td>
<td>$1.6 billion</td>
</tr>
<tr>
<td>Refundable SR&amp;ED tax credits for CCPCs</td>
<td>$1.6 billion</td>
</tr>
</tbody>
</table>

Non-profit organizations

The 2017 budget measures could contain measures affecting non-profit organizations. In the 2014 federal budget, Finance announced it would conduct public consultations to determine whether the income tax exemption for NPOs is properly targeted and whether
there is sufficient transparency and accountability. However, the results of this consultation have not yet been publicly announced.

**Indirect tax**

*Expanding the selected listed financial institution (SLFI) rules*

Finance could propose 2017 budget measures based on the results of its recent consultation on the GST/HST rules for certain limited partnerships and investment plans. In this consultation, Finance asked for comments on proposals to:

- Expand the selected listed financial institution (SLFI) rules to include certain investment limited partnerships.
- Include “investment limited partnership” in the definition of “investment plan” for GST/HST purposes
- Generally consider an investment limited partnership to be a SLFI if it has a permanent establishment in an HST province and a permanent establishment in any other province
- Change the rules for determining provincial attribution percentages of investment limited partnerships that qualify as SLFIs
- Expand the self-assessment rules
- Introduce a new GST rebate for certain investment plans that have non-resident investors.

For details, see *TaxNewsFlash-Canada 2016-38, "New GST Rules and Consultations Touch Many Bases".*

**New capital investments in affordable rental housing**

In addition, the government may introduce legislation to address the Liberal’s unfulfilled 2015 election promise to encourage the construction of new rental housing by removing all GST on new capital investments in affordable rental housing.

**International tax**

*Multilateral instrument*

Canada may also introduce legislation to adopt the multilateral instrument, which is expected to modify more than 2,000 tax treaties worldwide in order to facilitate the implementation of related BEPS measures. The multilateral instrument was developed as
part of Action 15 of the OECD’s BEPS initiative (see TaxNewsFlash-Canada 2016-55, "Tax Treaties Poised to Include BEPS Measures").

**Treaty shopping**

In the 2016 federal budget, Canada confirmed its commitment to address treaty abuse in accordance with the BEPS minimum standard. In this year’s budget, the government may clarify whether it will introduce a limitation-on-benefits rule, principal purposes test, or some combination of the two in its treaties to target treaty shopping.

**Complete tax-sensitive transactions before budget day**

As with any budget, there’s no telling what types of changes the government may have in store this year. Since federal budgets often propose measures that take effect on budget day, your best defense against adverse tax changes is to complete or close all tax-sensitive transactions before budget day, if it makes sense from an investment perspective.