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BUDGET 2016: ELIGIBLE CAPITAL PROPERTY RULES REVAMPED

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Budget 2016 proposes to repeal the current rules governing the taxation of eligible capital property ("**ECP**") and transition the current ECP regime into the more general capital cost allowance ("**CCA**") system provided for under the *Income Tax Act* (the "**Tax Act**").

The proposals contained in Budget 2016 were first announced in concept by the Government in 2014 and were the subject of consultations conducted by the Department of Finance over the past two years. In Budget 2015, the Government indicated that draft legislative proposals would be released in due course. It was widely expected that detailed legislative amendments relating to the tax treatment of ECP would be released in Budget 2016.

The current rules governing the taxation of ECP have become increasingly complex and difficult to navigate. The ECP regime stands in stark contrast to the CCA system that guides the deductions that may be claimed in respect of most other types of capital property. While the proposed amendments will simplify reporting and computational requirements, the transition to the new system may introduce new compliance challenges for many existing businesses and will eliminate many historical tax deferral opportunities.

Background

Capital expenditures are generally not deductible in computing a taxpayer's income from a business unless specifically permitted under certain provisions of the Tax Act. One such provision permits discretionary deductions, in the form of CCA, to be claimed in respect of the cost of depreciable capital property, based on prescribed maximum rates of depreciation. Such maximum deduction rates must generally be applied on a declining-balance basis to the "undepreciated capital cost" of the property. Different types of depreciable property are assigned to various pools, or "classes", of assets, each having its own prescribed rate of depreciation. Upon the disposition of depreciable capital property, amounts received by a taxpayer in respect of the property can give rise to income in the form of recaptured tax depreciation (or, in certain circumstances, a loss on income account) and/or a capital gain.

However, capital expenditures in respect of certain types of intangible property, such as a customer list or

goodwill of an acquired business, generally do not result in the acquisition of an asset that falls within one of the classes of depreciable property in respect of which CCA may currently be claimed. Nevertheless, under the current system, such expenditures could qualify as eligible capital expenditures ("**ECE**") where they were incurred to acquire a right or benefit of an intangible nature for the purpose of earning income from a business.

Conversely, under the current system, an "eligible capital receipt" is generally regarded as an amount that is received on capital account in respect of a business with respect to rights or benefits of an intangible nature, other than an amount that is otherwise required to be included in income or an amount that is on account of proceeds of disposition of a capital property.

Under the current ECP regime, three-quarters (or 75%) of the amount of an ECE incurred by a taxpayer is added to the taxpayer's "cumulative eligible capital" ("**CEC**") pool in respect of the business to which it relates and is amortized at a rate of 7% per year on a declining-balance basis. Similarly, three-quarters (or 75%) of an eligible capital receipt received by a taxpayer is deducted from the relevant CEC pool.

Where, as a result of a deduction from a CEC pool, the balance of the CEC pool becomes negative, the amount of the negative balance is required to be fully included in the taxpayer's income, as recaptured deductions, to the extent of any previously deducted amounts on account of CEC. Once all of the previously deducted amounts have been recaptured, the equivalent of one-half (or 50%) of the difference between the amount received for the subject ECP and the previously claimed deductions (the "**ECP Gain**") is included in the taxpayer's income from the business. (The resulting tax treatment of the ECP Gain is similar to that which applies to capital gains realized from the disposition of capital property, at least in terms of the quantum of the income inclusion.)

Introduction of New Class 14.1

Budget 2016 proposes the introduction of a new class of depreciable property for CCA purposes, effective January 1, 2017. Expenditures that are currently added to a taxpayer's CEC pool at a 75% inclusion rate will instead be fully included in a new CCA class (Class 14.1). However, instead of being deductible at a 7% rate, as is currently the case in respect of amounts in a taxpayer's CEC pool, the new CCA class will have a maximum annual prescribed rate of depreciation of 5%, which will be applied on a declining-balance basis. The existing rules governing CCA will generally apply to the new CCA class, including the rules relating to recaptured CCA, capital gains, as well as the "half-year rule", which generally applies to reduce by half the amount of CCA that can otherwise be claimed by a taxpayer in respect of depreciable capital property in its year of acquisition.

Transitional Rules

Budget 2016 proposes a detailed set of transitional rules that will govern the transition of the tax balances of existing businesses with ECP to the new CCA regime. Beginning on January 1, 2017, new CCA Class 14.1 will include (i) the goodwill associated with a taxpayer's business, (ii) property that was ECP of the business before January 1, 2017, and (iii) property acquired on or after January 1, 2017, the cost of which would have historically have been treated as an ECE.

A separate Class 14.1 will be maintained in respect of each business of a taxpayer. While CCA in respect of property acquired on or after January 1, 2017 that is added to Class 14.1 may only be claimed at a rate of 5% on a declining-balance basis, the proposed transitional rules provide that, for a period of ten years (until 2027), a taxpayer will be entitled to claim CCA at a rate of 7% in respect of property that was owned by the taxpayer prior to 2017 and was added to Class 14.1 under the transitional rules.

The transitional rules generally provide that the "undepreciated capital cost" ("**UCC**") of property in new Class 14.1 in respect of a business at the beginning of 2017 will be equal to the amount that would have been the CEC balance in respect of the business at the beginning of 2017.

The transitional rules facilitate the transition to the new regime by applying a series of deeming rules to the existing CEC balances of a taxpayer. First, the transitional rules deem the total capital cost of all ECP held by a taxpayer at the end of 2016, which will be placed in new Class 14.1 at the beginning of 2017, to cumulatively equal the total of (i) 4/3 of the amount of the taxpayer's CEC balance in respect of its business at the beginning of 2017, and (ii) 4/3 of the amount of past deductions claimed in respect of ECP by the taxpayer that have not previously been recaptured.

The computation of the total capital cost of the property to be included in new Class 14.1 is important for determining the amount of gains and recapture that might be incurred by a taxpayer in the future. However, the total capital cost of the property to be included in new Class 14.1 is not required to be calculated at the beginning of 2017 to be able to determine the amount of CCA that may be claimed going forward, as the UCC of the property in Class 14.1 will generally be deemed to be equal to the corresponding CEC of the taxpayer at the beginning of January 1, 2017. (Special adjustments to the capital cost of property placed in new Class 14.1 may arise if the taxpayer has a taxation year that straddles January 1, 2017 (a "**Straddle Year**"), and the taxpayer receives an eligible capital receipt in the Straddle Year, yet before January 1, 2017.)

Second, the transitional rules contain elective provisions that will generally permit taxpayers to allocate the cumulative capital cost of their ECP among each such property for the purposes of determining the capital cost of each ECP on January 1, 2017. Specifically, taxpayers will be permitted to designate the order in which the capital cost of each of their eligible capital properties (other than goodwill property) will be determined. Once an order is determined, the capital cost of each particular eligible capital property on the list will be deemed to

be the lesser of (i) the ECE that the taxpayer originally made in respect of the particular property, and (ii) the amount by which the cumulative capital cost of all ECP of the taxpayer exceeds amounts previously allocated to the ECP of the taxpayer further up the taxpayer's list. The net result of this ordering rule is that taxpayers will be permitted to set the capital cost of particular ECP at an amount up to the original expenditure made to acquire such property, subject to the cumulative capital cost of all of its ECP equalling 4/3 of its CEC and its past deductions in respect of CEC that were not recaptured. The capital cost of a taxpayer's "goodwill property" will, by extension, effectively represent the residual capital cost of its ECP after capital costs have been allocated to all of the other ECP of the taxpayer. If a taxpayer fails to designate an order of allocation for its ECP, the Minister of National Revenue (the "**Minister**") is permitted to designate an order.

Third, the transitional rules include a deeming rule that will generally deem the UCC of the property in new Class 14.1 to be equal to the CEC balance of the taxpayer at the beginning of 2017. The difference between the total capital cost of the property in Class 14.1 and the CEC balance of the taxpayer at the beginning of 2017 will be deemed to be CCA claimed by the taxpayer in respect of its Class 14.1 property. The deemed CCA claimed in respect of Class 14.1 will be relevant to determining the degree to which CCA may be recaptured on a subsequent sale of Class 14.1 property.

As noted above, the transitional rules contain special elective provisions that deal with circumstances under which a taxpayer has a Straddle Year and the taxpayer disposes of ECP in the Straddle Year, yet prior to January 1, 2017. Under such circumstances, the amount by which (i) the CEC balance of the taxpayer would be negative (if the taxpayer's taxation year had ended at the end of 2016), exceeds (ii) the deductions previously claimed in respect of ECP will be deemed to be a capital gain, rather than an income inclusion, unless the taxpayer elects with the Minister before the taxpayer's filing-due date for the relevant taxation year for the amount to instead be included in computing the income of the taxpayer from a business or property. The taxpayer will also be permitted to elect to offset any capital gain or income inclusion by the amount of goodwill or other Class 14.1 property acquired by the taxpayer subsequent to January 1, 2017, but prior to the end of the Straddle Year. In this regard, the transitional rule will operate in a manner consistent with how the ECP regime has historically operated to allow taxpayers to defer income inclusions in respect of a gain on the sale of ECP where new ECP is acquired prior to the end of the relevant taxation year.

The transitional rules contain specific provisions to preclude a taxpayer that held ECP at the beginning of January 1, 2017 from being considered to have recaptured CCA in excess of the deductions previously claimed in respect of such ECP. In this regard, difficulties may arise because, while only 75% of the capital cost of historical ECP will have been eligible to be deducted for tax purposes, comparable property that is acquired after 2016 will be fully included in Class 14.1 and the cost of such property will be eligible to be fully deducted as CCA over time. Absent corrective measures, on a subsequent sale of historical ECP, the rules in the Tax Act

could apply to deem the taxpayer to have recaptured CCA up to the original acquisition cost of the property, which would exceed the deductions in respect of such property that would have been claimed by the taxpayer. Accordingly, the transitional rules provide that, immediately before the sale of historical ECP, the UCC of Class 14.1 will generally be "grossed-up" to account for the fact that only 75% of the original acquisition cost of such property was eligible to be deducted.

Complicated formulae and anti-avoidance rules apply to preclude excessive gross-ups. The transitional rules also provide that the gross-up will not be available where property is transferred pursuant to certain roll-over provisions (which may prove to be a trap for the unwary in the future).

The transitional rules also contain certain anti-avoidance provisions that are aimed at precluding taxpayers that hold property that was previously ECP (and, therefore, deductions in respect of which could only be claimed on 75% of the capital cost of the property) from engaging in non-arm's length transactions to "bump" up the capital cost against which CCA may be claimed in the future. The anti-avoidance rule operates to grind down the capital costs against which CCA may be claimed when certain non-arm's length transactions are executed that would otherwise have the effect of bumping up the capital costs of such property.

Finally, Budget 2016 proposes to introduce special rules in respect of goodwill, as well as expenditures and receipts that do not relate to a specific property.

The definition of what constitutes "property" for income tax purposes is broad and includes, among other things, a right of any kind whatever. As a result, most of what currently constitute eligible capital expenditures and receipts relate to acquisitions or dispositions of specific property. However, this is not the case in respect of all expenditures and receipts.

To accommodate all expenditures and receipts that were formerly captured by the ECP regime in new CCA Class 14.1, it is proposed that every business of a taxpayer will be considered to have a single "goodwill property" associated with it, even in the absence of any purchased goodwill. The definition of "property" in the Tax Act will be amended to provide that goodwill of a business will be "property" for the purposes of the Tax Act. Any future capital expenditure or receipt that does not relate to the acquisition or disposition of a specific property will be accounted for by adjusting the capital cost of the goodwill of the business and, consequently, the balance of the new CCA class. Expenditures unrelated to particular property will increase the capital cost of goodwill and, therefore, the balance of the new CCA class, whereas receipts unrelated to particular property will reduce the capital cost of the goodwill and, consequently, the balance of the new CCA class by the lesser of the capital cost of the goodwill and the amount of the receipt. To the extent the amount of the receipt exceeds the balance of the new CCA class, any previously deducted CCA will be required to be included in the taxpayer's income. If the amount of the receipt exceeds the original capital cost of the goodwill, the amount of such excess will be

treated as a capital gain. Special rules will also apply to adjust the balance of Class 14.1 where the taxpayer (i) acquires goodwill as part of a property acquisition that is consolidated into the taxpayer's existing business, or (ii) disposes of goodwill, but continues to carry on its existing business.

Small Business Transitional Rules

In Budget 2014, the Government indicated that it would introduce special transitional rules focused on small businesses to ensure that the transition to the new CCA regime can be accomplished quickly and without long-term compliance burdens. Budget 2016 proposes two special transitional rules that are aimed at limiting compliance burdens for small businesses.

First, to allow small CEC balances, which arose prior to January 1, 2017 and are transitioned to the new CCA class, to be eliminated quickly, the Government has proposed that a taxpayer will effectively be permitted to deduct CCA in respect of ECE incurred before 2017 at a rate equal to the greater of (i) the amount otherwise deductible at the applicable 7% rate, and (ii) $500 per year. By way of simple example, if a taxpayer had a $1,000 CEC balance that is transitioned to the new CCA class, under the general proposed transitional rules, the taxpayer will be entitled to claim CCA at a rate of 7% per year on a declining balance basis (i.e. $70 in Year 1, $65.10 in Year 2, etc.), which would thereby require the taxpayer to keep track of its relatively nominal pre-2017 ECE for an extended period of time. However, under the special small business transitional rules, the taxpayer will be entitled to claim $500 of CCA per year in respect of its pre-2017 ECE, thereby allowing the historical balance to be fully deducted within two years. The $500 minimum CCA deduction in respect of historical ECE will be permitted to be claimed by taxpayers in respect of any taxation year that ends prior to 2027.

Second, many stakeholders have noted that businesses have historically had relatively small CEC balances generated solely by incorporation expenses. The Government proposes to address what may be nominal additions to the new CCA pool by instead permitting the first $3,000 of such expenditures to be deducted as a current expense, rather than be added to new CCA Class 14.1. The Government estimates that approximately 80% of all newly incorporated businesses will be able to fully deduct the amount of such expenses in their year of incorporation by virtue of this new deduction.

Observations and Planning Considerations

The new taxation rules relating to what was formerly ECP raise a number of compliance issues and planning considerations.

First, under the current ECP regime, 50% of the portion of any eligible capital receipts in excess of (i) a taxpayer's CEC pool balance, and (ii) the total deductions previously taken on account of CEC (i.e., the ECP Gain) would be included in the taxpayer's business income. In this regard, even though the excess amount giving

rise to an ECP Gain is essentially taxed in a manner similar to a capital gain, the amount of the ECP Gain is nevertheless considered business income for purposes of the Tax Act.

Under the proposed rules, the amount corresponding to what would have been an ECP Gain will now be treated as a capital gain. For a "Canadian-controlled private corporation" (a "CCPC") carrying on an active business, an ECP Gain under the ECP regime can potentially be eligible for the small business deduction and, therefore, taxed at a significantly lower corporate tax rate than a capital gain, which would be subject to the rate applicable to investment income.[1]

Moreover, such income would not be considered to be part of the "aggregate investment income" of the CCPC and, therefore, would generally not need to be distributed by the CCPC to its shareholders as a dividend to recoup the refundable tax that would be levied on such income. The transition to the new CCA regime will eliminate the deferral advantage that was previously enjoyed by individuals that operated businesses through a CCPC and would have previously allowed an ECP Gain to remain with the CCPC. Stakeholders brought these implications to the attention of the Government; however, the Budget documentation expressly indicates that the Government did not view such results as improper from a policy perspective. CCPCs that have material holdings of ECP may wish to consider the possible tax advantages associated with potentially "bumping up" or disposing of ECP in a taxable transaction prior to the end of 2016.

Conversely, taxpayers that are considering the acquisition of property that would currently be characterized as ECP may wish to consider the prudence of deferring such acquisitions until 2017. While the effective rate at which tax depreciation may be claimed in respect of such property will nominally be reduced from 5.25% to 5% subsequent to 2016, 100% of the capital costs of such property may be depreciated for tax purposes over time versus only 75% of the capital cost of ECP. Therefore, the cumulative tax deductions that may ultimately be claimed, particularly where it is anticipated that property will be held for an extended period, may be greater under the new regime.

As illustrated above, the transitional rules that will apply to businesses that own material amounts of ECP will impose complicated tracking and computational obligations. While the computation of the capital cost of property being transferred to new Class 14.1 will not be immediately required in order to compute CCA in respect of property in the class, such amounts will need to be computed upon the disposition of such property. Taxpayers would be well advised to immediately begin assembling the data to make such computations, rather than waiting to collect such data in the future when it might have been lost or might not be readily available.

Finally, there are a number of exceptions to the general application of the transitional rules, including certain anti-avoidance provisions, that taxpayers will need to keep in mind. Prior to undertaking any transactions

involving ECP, taxpayers will need to carefully consider the implications of contemplated transactions under the transitional rules.

by Michael Friedman

[1] For 2016, the applicable combined federal and provincial corporate tax rates on income of a CCPC that is eligible for the small business deduction are 15.9% and 18.5% in Ontario and Québec, respectively, whereas the rates applicable to investment income are 50.2% and 50.6%, respectively.[ps2id id='1' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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