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Tax & Estate

2018 Federal Budget analysis

The 2018 Federal Budget was tabled by the Liberal Party on Tuesday, February 27, 2018. It was the third budget of the Liberal government and Finance Minister Bill Morneau.

As is our practice, we focus this report and analysis on the key issues that are relevant to personal taxation, financial planning, investment portfolios and related private corporation taxation matters.

Much of the focus of this budget was in respect to the comprehensive tax reforms related to tax planning through Canadian Controlled Private Corporations (CCPCs) or private corporations. As promised, Budget 2018 delivered proposals on the taxation of passive investment income earned through a private corporation. Relative to the initial proposals announced in July 2017 and modified shortly after, in October 2017, the budget introduces amendments that simplify the approach, choosing to focus on access to the small business deduction.

The 2018 Budget also introduces a series of measures aimed at strengthening the Canada Revenue Agency's (CRA) reassessment capabilities in various circumstances. These measures include proposals that make it easier for the CRA to share information with foreign jurisdictions that extend beyond taxation matters.

Finally, with the legal sale of cannabis set to begin on July 1, 2018, sales and excise tax proposals have been introduced to set the basic framework for the taxation of cannabis.

1. Tax planning using private corporations

Passive investment income and the small business deduction

The initial reforms called for a limit ($50,000) to which a private corporation could earn passive investment income without running afoul of a set of punitive tax rules. The new measure targets the deferral advantage that private corporations enjoy on the first $500,000 (federally) of active business income and will apply to taxation years starting after 2018. Recall that active business income is taxed at favourable low rates, generally resulting in a private corporation's after-tax income being greater than otherwise earned and taxed at the individual tax rates. This difference was the deferral advantage, as more after-tax proceeds are available to accumulate passive investments within the private corporation.

The new measures introduce a reduction in the small business deduction available for private corporations having between $50,000 and $150,000 in passive investment income. The measures will affect private corporations only if their business income exceeds the calculated reduced business limit. Provided that the calculated reduced business limit remains above actual active business income, there will be no impact to the private corporation, and all active business income will be taxed at the small business tax rates.

As per the budget documents, the proposal is to reduce the small business deduction limit by $5 for every $1 of investment income above $50,000, with a complete elimination of the small business deduction limit when passive investment income reaches $150,000.

As an example, where a private corporation earns $75,000 in passive investment income, the first $50,000 of passive investment income will be exempt and will not affect the small business deduction. The excess $25,000 in passive investment income will reduce the available small business deduction limit at a rate of $5 for each $1 above the $50,000. In our example, the small business deduction is reduced by $125,000. The private corporation thus has $375,000 to be applied on active business income at the preferred tax rates. Provided that its actual active business income is at or below the reduced active business limit of $375,000, there will be no impact to the private corporation. Any active business income earned above this reduced small business limit will be taxed at the general corporate tax rates.

The reduction in access to the small business deduction is intended to target private corporations that have higher levels of retained earnings that are deployed into generating income from passive investments, as opposed to reinvesting the earnings back into the business. The Department of Finance has indicated that about 3% of private corporations will be affected by this new measure. Additionally, there are rules currently in place that reduce access to the small business deduction for private corporations with taxable capital in excess of $15 million.

The calculations will be based on a new concept of "adjusted aggregate investment income," which generally includes income that is subject to the refundable tax with adjustments for the following:

- Taxable capital gains (losses) on property used in the active business in Canada will be excluded
- Taxable capital gains (losses) on shares or another connected private corporation where all or substantially all is used principally in an active business in Canada will be excluded
- Net capital losses carried over from other years will be excluded
- Dividends from non-connected corporations will be added
- Income from a non-exempt life insurance policy will be added to the extent that it is not otherwise included in aggregate investment income
- Aggregate investment income that is incidental to an active business will be excluded

The rules also prevent any transaction aimed at deferring the application of the measures through various transfers to related corporations not associated with the private corporation.

The budget also reconfirms the $500,000 federal limit on active business income with the general corporate income tax rates at 15% and the small business income tax rate at 10% for 2018 (reduced to 9% in 2019), as previously announced.

Changes to refundability of taxes on investment income

Canada's tax system attempts to integrate the overall imposition of tax, such that an individual should have no preference regarding the earning and distribution of income through a private corporation or earned as an individual directly. Investment income earned by a private corporation is taxed at approximately the same rate that would apply to an individual at the top marginal rate while that income is retained in the corporation. A portion of the taxes paid on a private corporation's passive investment income is tracked by a single notional account called the refundable dividend tax on hand (RDTOH) and is refunded to the corporation upon the corporation paying a taxable dividend to its shareholders. In a way, the refundable nature of the RDTOH provides an incentive for the corporation to pay a taxable dividend to its shareholders.

For income tax purposes, taxable dividends paid by private corporations are either "eligible" or "non-eligible." Non-eligible dividends are presumed to be paid from a corporation's active business income that has been subject to the small business tax rate or from passive investment income, but excluding the non-taxable portion of capital gains, as well as eligible portfolio dividends (e.g., dividends paid from a mutual fund corporation to a corporate investment account). An individual who receives non-eligible dividends is entitled to the ordinary dividend tax credit. Eligible dividends are presumed to be paid from a corporation's active business income that has been subject to the higher general corporate tax rate, including eligible dividends received by the corporation. An individual who receives an eligible dividend is entitled to receive an enhanced dividend tax credit. From an individual tax perspective, eligible dividends are tax preferred due to the higher dividend tax credit.

A corporation may obtain a refund of taxes paid on investment income, reflected in the corporation's RDTOH account, regardless of whether the dividends paid are eligible or non-eligible. As a result, the current system allows a corporation to receive an RDTOH refund upon the payment of an eligible dividend in situations where the corporation's RDTOH was generated from investment income that would need to be paid as a non-eligible dividend to ensure approximate integration of tax between the corporation and the individual shareholder. This can provide a tax deferral advantage on passive investment income by allowing private corporations paying eligible dividends sourced from active business income taxed at the general corporate tax rate to generate a refund of taxes paid on passive income.

Budget 2018 proposes that a refund of RDTOH will generally only be available in cases where a private corporation pays non-eligible dividends. . The new system will require the private corporation to track two RDTOH accounts: an eligible and non-eligible account. The eligible RDTOH account will track taxes paid on eligible portfolio dividends only. Any taxable dividend (i.e., eligible or non-eligible) paid will entitle the corporation to a dividend from its eligible RDTOH account (subject to an ordering rule discussed below).

The current RDTOH account (which is now called the non-eligible RDTOH account) will track refundable taxes on a corporation's taxes paid on investment income as well as taxes paid on non-eligible portfolio dividends (i.e., dividends paid by non-connected corporations as non-eligible dividends). Refunds from this account will only be obtained upon the payment of non-eligible dividends.

Ordering rule – Upon payment of a non-eligible dividend, a private corporation will be required to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

An anti-avoidance rule will apply to prevent a deferral of the application of this measure through the creation of a short taxation year. Both of these above measures, if enacted, will apply to taxation years starting after 2018.

2. Federal income tax brackets 2018

There were no changes to federal income tax brackets and rates, other than the usual annual indexing of brackets from 2017. The 2018 tax brackets and rates are as follows:

Income from	Rate
$11,809	15.0%
$46,605	20.5%
$93,208	26.0%
$144,489	29.0%
$205,842	33.0%

3. Reporting requirements for trusts

Currently, only trusts that earn income or make a distribution to their beneficiaries in a taxation year are required to file a T3 return of income for that year. A T3 return of income is not required in a year where the trust has no earned income and makes no distributions to its beneficiaries. Furthermore, in the event a T3 return needs to be filed, there is no requirement for the identity of all the trust's beneficiaries to be reported.

Budget 2018 reiterates and expands the government's intention expressed in Budget 2017 to enhance the tax-reporting requirements for trusts by requiring that certain trusts provide additional information on the beneficial owners and controlling persons of a trust on an annual basis.

The new reporting requirements will apply to Canadian-resident trusts and to non-resident trusts that are currently required to file a T3 return. Budget 2018 proposes to exempt certain types of trusts, such as mutual fund trusts, segregated funds trusts, trusts governed by registered plans, lawyers' general trust accounts, graduated rate estates and qualified disability trusts and trusts in existence less than three months or that hold less than $50,000 in assets throughout the taxation year (provided, with respect to the latter, that the assets are confined to deposits, government debt obligations and listed securities).

If a trust is subject to the new reporting requirements, it will be required to report on a T3 beneficial ownership schedule that is to be introduced by the government for the identities of

- all trustees of the trust,
- all beneficiaries of the trust,
- all settlors of the trust, and
- any person who has the ability to exert control over the trustee's decisions regarding the distribution of income or capital.

These new reporting requirements will apply to returns required to be filed for the 2021 taxation year and subsequent taxation years. Penalties are also proposed for failure to file a T3 return once this new reporting requirement comes into effect.

4. Changes to various tax credits

Canada Workers Benefit

The Working Income Tax Benefit has been rebranded as the Canada Workers Benefit. It is a refundable tax credit that has been enhanced to support low-income individuals and families who are working. The proposals will apply to the 2019 and subsequent taxation years. Indexation will continue to apply after 2019.

Single individuals without dependants

- Calculated as 26% of each dollar of earned income in excess of $3,000
- Maximum benefit: $1,355
- Reduction rate: 12% of adjusted net income in excess of $12,820
- Phase-out income threshold: $24,111

Families (couples and single parents)

- Calculated as 26% of each dollar of earned income in excess of $3,000
- Maximum benefit: $2,335
- Reduction rate: 12% of adjusted net income in excess of $17,025
- Phase-out income threshold: $36,483

Disability supplement

- Increased to $700 for 2019
- Reduction rate: 12% to match the basic benefit, and 6% if both partners in a family are eligible for the supplement
- Same phase-out income thresholds for single individuals and families as mentioned above

Improving access

Currently, qualifying individuals cannot obtain the benefit unless they apply using Schedule 6. Budget 2018 proposes to allow the CRA to proactively determine if individuals are eligible to receive the benefit and assess their returns as if the benefit had been claimed. However, Schedule 6 should still be completed to properly determine eligibility for the benefit and to avoid potential delays.

In addition, designated educational institutions in Canada will be required to report information to the CRA in order to assist in the administration of the benefit.

Medical Expense Tax Credit

The Medical Expense Tax Credit currently provides tax relief for certain expenses incurred for an animal trained to assist a patient in coping with specified impairments (e.g., blindness). Some examples of the current eligible expenses are the cost to obtain such an animal as well as food and veterinary expenses. The proposal further recognizes eligible expenses related to an animal specially trained to assist patients in coping with a severe mental impairment (e.g., a service dog trained to assist with post-traumatic stress disorder). In order for the expenses to be eligible, the animal must be specially trained to perform the specified tasks.

Mineral Exploration Tax Credit for flow-through share investors

Flow-through shares have the ability to renounce expenses associated with Canadian exploration activities to investors. These investors can in turn deduct the expenses from their own taxable income. The mineral exploration tax credit provides an additional tax benefit to flow-through share investors. The credit is equal to 15% of specified mineral exploration expenses incurred in Canada and flowed through to investors. The proposal extends the eligibility for the credit for an additional year on agreements entered into on or before March 31, 2019.

5. Charities

Municipalities as eligible donees

The *Income Tax Act* (Canada) incentivizes donations to charitable organizations registered with the CRA via tax credits for individual donors and deductions for corporate donors. When a charitable organization loses its charitable status, or its status is revoked, it is subject to a 100% tax on its remaining assets. Charities are able to reduce their assets by making qualifying expenditures, including gifts, to "eligible donees." In general, "eligible donees" were previously limited to other registered charities. Budget 2018 proposes to amend the definition of qualifying expenditures to include transfers to municipalities, subject to review on a case-by-case basis. This measure went into effect on February 27, 2018.

Universities outside of Canada

Canadians are generally eligible to claim the charitable donation tax credit for donations made to "qualified donees," which includes some universities outside of Canada that have been recognized by the CRA. Administratively, two separate lists of universities outside of Canada considered to be "qualified donees" are maintained: one under Schedule VIII of the Income Tax Regulations and another on the Government of Canada's website. In order to eliminate the redundancy of maintaining two identical lists, Budget 2018 proposes to remove the requirement that such institutions be listed under the Income Tax Regulations.

6. Deductibility of employee contributions to the enhanced portion of the Quebec Pension Plan (QPP)

Enhancements to the Canada Pension Plan (CPP) were announced in the 2016 Federal Budget and are to be introduced incrementally over the taxation years 2019 to 2025. Those enhancements will mean greater mandatory contributions to the CPP and greater benefits for CPP pensioners. In keeping with the tax treatment of employee contributions to the base portion of the CPP (and the employee portion of CPP contributions made by self-employed individuals), Budget 2016 confirmed that individuals will be eligible to claim a deduction for their contributions to the enhanced portion of the CPP.

On November 2, 2017, the Government of Quebec announced that similar measures to those proposed for the CPP would be introduced to the QPP over a similar timeframe. Budget 2018 proposes to streamline the tax treatment of both the CPP and QPP enhancements by allowing for a deduction of employee contributions (and the employee portion of QPP contributions made by self-employed individuals) to the enhanced portion of the QPP.

7. Qualifying plan holder on registered disability savings plans (RDSP)

The *Income Tax Act* (Canada) requires the legal representative of a mentally incapacitated RDSP beneficiary to be the plan holder of the RDSP. Due to the lengthy and expensive process in establishing a legal representative, a temporary federal measure exists to allow qualifying family members (i.e., a parent, spouse or common-law partner) of the beneficiary to be the plan holder. This measure was set to expire at the end of 2018 and is proposed to be extended by five years, until the end of 2023.

8. Potpourri

Measures affecting financial institutions

Synthetic equity arrangements and securities lending arrangements

Through a series of targeted measures, Budget 2018 aims to remove any unintended tax advantage through arrangements that circumvent the dividend rental arrangement rules introduced in Budget 2015. The new rules will target so-called synthetic equity arrangements and securities lending arrangements that target losses created artificially.

At-risk rules

The partnership business structure allocates the income (or loss) of the business to its individual partners, who include that income (or loss) on their personal tax returns. Losses incurred by a limited partnership may be deducted by the partners, to the extent that those losses do not exceed their "at-risk amounts" in the partnership. The at-risk amount is generally equal to a partner's capital interest in the partnership, in addition to any unpaid income allocated to him or her. Those losses in excess of the at-risk amount that cannot be deducted become "limited partnership losses" and are generally eligible to be carried forward indefinitely, until a partner's at-risk amount increases. If a partner's at-risk amount does not increase, he or she will be prevented from deducting the loss in a future year. In such cases, upon the disposition of the partner's interest, the limited partnership loss can be used to increase the adjusted cost base of the partner's partnership interest, serving to reduce the capital gain or increase the capital loss that arises.

The at-risk rules have traditionally been applied to so-called "tiered partnerships" (i.e., limited partnerships where the partnership interest in that partnership is held by another partnership). While the carryforward of limited losses was generally not permitted for tiered partnerships, an addition of those losses to the adjusted cost base of the tiered partner typically was. A recent Federal Court of Appeal ruling has undermined the application of the at-risk rules to tiered partnerships. The 2018 Federal Budget proposes to introduce clearer rules that reinforce the CRA's previous policy of extending the at-risk rules to tiered partnerships. Going forward, limited partnership losses will continue to apply to partners in a tiered partnership, to the extent of the partner's at-risk amount (i.e., the partner's interest in the limited partnership).

Stop-loss rule on share repurchase transactions

Budget 2018 proposes to amend the *Income Tax Act* (Canada) regarding shares held as mark-to-market property so that the tax loss otherwise realized on a share repurchase is generally decreased by the deemed dividend received on that repurchase when that dividend is eligible for the inter-corporate deduction. This new amendment seeks to close loopholes that allow Canadian financial institutions to circumvent stop-loss rules and realize an artificial tax loss on share repurchases by fully hedging the repurchased shares.

Sharing information on criminal matters, tax matters and non-tax offences

Measures have been put into place to strengthen the ability for Canada to share information with its international partners in the global fight against serious crime offences, tax offences and non-tax related offences.

Strengthening reassessment periods

Requirements for information and compliance orders

Budget 2018 introduces measures that remove any disadvantage on the CRA in respect to requests for information and compliance orders that are being contested in court. Generally, the ability to reassess a tax year is restricted to three or four years from the initial assessment of the tax year in question before it becomes statute barred. The new measures allow the CRA the ability to "stop the clock" in situations where there is a contestation regarding a request for information or compliance orders. The move aligns it with current existing measures related to contested requests for information and compliance orders for foreign-based information.

Non-resident non-arm's length individuals

In situations where a loss in incurred and carried back to be applied against a previous tax year, the CRA generally has an additional three years to reassess a particular tax year for that prior taxation year before it becomes statute barred. Measures have been introduced to allow the CRA to reassess a tax return for transactions between a Canadian taxpayer and a non-resident non-arm's length person. The rule will apply to losses carried back from a taxation year ending on or after budget day.

Health and Welfare Trusts

A Health and Welfare Trust (HWT) is a trust established by an employer to provide health and welfare benefits to its employees. Rules have been implemented to align provisions related to the treatment of surplus income and pre-funding of benefits within a HWT, with existing rules introduced in 2010 in respect of Employee Life and Health Trusts. The CRA is expected to apply their administrative positions on Employee Life and Heath Trusts to HWTs beginning in 2021, and HWTs that do not convert or wind up will be taxed as trusts. Additionally, HWTs established after budget day will be subject to the transitional rules. Request for public comments on this measure is open until June 29, 2018.

Retroactive eligibility of foreign-born status Indians

Foreign-born status Indians who are neither Canadian citizens nor permanent residents of Canada, but who legally reside in Canada may currently be eligible for certain federal, provincial and territorial programs and services, including the Canada Child Benefit.

However, foreign-born status Indians were previously excluded from eligibility for discontinued childcare benefits, including the Canada Child Tax Benefit, the National Child Benefit supplement and the Universal Child Care Benefit. Budget 2018 proposes to extend eligibility for those childcare benefits to those individuals retroactively, provided that all other eligibility requirements are met. This amendment applies to childcare benefits from taxation years 2005 to June 30, 2016.

Tax support for clean energy

In the 2005 Budget, the government introduced beneficial accelerated capital cost allowance rates for investments in specified clean energy generation and conservation equipment acquired before 2020. Budget 2018 proposes to extend eligibility for those rates by five years so that it is available for property acquired before 2025.

Tobacco tax

Excise duty rates on tobacco products are currently set to automatically increase every five years to account for inflation. Budget 2018 proposes to advance the inflationary adjustments for tobacco excise duty rates to occur on an annual basis rather than every five years. The inflationary adjustment is to occur each year on April 1, beginning in 2019. A Budget 2018 day inflationary adjustment was made to account for inflation that occurred since the last adjustment in 2014.

Cannabis taxation

The 2018 Federal Budget proposes to add a federal excise duty framework for cannabis products to the *Excise Act*, 2001. This duty will generally apply to all cannabis products legally available for purchase. This framework will be in effect when cannabis becomes available for retail sale (for non-medical purposes). Transitional rules are also in place to regulate distribution until legalization occurs.

The federal government reached a taxation coordination deal with the provinces and territories in December 2017 for the first two years after cannabis legalization. This deal mandates that 75% of the taxation revenues from a combined $1 per gram and 10% excise duty will go to the participating provinces and territories. The remaining 25%, up to a maximum of $100 million annually, will remain with the federal government for each of the first two years. Any federal revenues in excess of $100 million annually will be distributed to the participating provinces and territories.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at invesco.ca.

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