FEDERAL BUDGET 2018

INSIGHTS FROM OUR TAX & ESTATE PLANNING PROFESSIONALS

On February 27, 2018, the Liberal government tabled the Federal Budget in a speech by Finance Minister, Bill Morneau. Consistent with Federal Budget 2017, the government has restated its focus on strengthening the middle class and increasing gender equality in Canada through investment in the economy and rejection of austerity measures.

The 2018 Federal Budget has been much discussed and awaited due to the expected changes to the taxation of private companies in Canada. In the intervening time since the 2017 budget, there has been extensive media coverage, and multiple announcements made by the Department of Finance with respect to these proposed corporate tax changes.

In July 2017, changes were proposed with respect to surplus stripping (the tax free extraction of surplus) and the multiplication of the capital gains exemption for qualifying property. These changes were subsequently dropped in October and replaced with a reduction to the small business tax rate as well as confirmation of the intention to proceed with the proposed legislation related to income sprinkling.

As announced on October 24, 2017 the indexing of the Canada Child Benefit amounts will be as of July 1 2018 instead of July 1, 2020.

The government has confirmed in Budget 2018 that it intends to proceed with lowering the small business tax rate to 10.5% January 1, 2018 and 9% effective January 1, 2019. This measure was tabled along with changes to the dividend gross up and dividend tax credit rates.

To address perceived abuses of the income tax system through income sprinkling among family members, the tax on split income ("TOSI") rules were introduced in December 2017, and effective in 2018. These rules now require that dividends paid to shareholders must meet a reasonability test going forward, and introduce the concept of a "specified individual" based on their age and relation to other shareholders. TOSI has extended on the concept known as "Kiddie Tax", where income received by specified individuals up until age 24 will be taxed at the top marginal tax rate. The dividend reasonability test for individuals age 25 and older would be based on capital contributed to the corporation or work performed in the business by the shareholder receiving the dividend.

While the budget introduces clarifications to complex security lending arrangements and share repurchase transactions as well as an advancement of the inflationary adjustments for tobacco taxation, and a one year extension for mining flow through shares, the focus was heavily weighted to taxation of corporately held investment income and the introduction of the legal cannabis trade in Canada.

This article will highlight some of the key measures proposed by the budget and the impact these initiatives will have on our clients and their families, specifically:

- **Taxation of passive investments held by corporations**
- **Amendments to the current refundable tax regime**
- **Increased transparency through new trust reporting rules**
- **Cannabis taxation**
- **Personal tax measures**
- **Reporting changes and further exposure for taxpayers with offshore investments**

Business Tax Measures

Passive Investments Held by Corporations

Prior to Budget 2018, active income earned by a corporation was traditionally taxed at corporate rates that are significantly lower than the top personal tax rate. Additional tax is then paid at the shareholder level when a dividend is paid from the corporation. Corporations that chose to retain these funds instead of paying a dividend, were able to benefit from a deferral of the personal level of taxation.

The government perceived an advantage for the corporation as there would be a higher initial amount of capital to invest, compared to an individual who received these funds personally for investment. As a result, the government has attempted to limit the amount of passive investment income earned in corporations.

After consultation with the public, it was determined that small businesses have difficulty accessing capital and therefore should be allowed some capital accumulation to support future capital expenditures for their active business.

The proposed rules initially introduced could have been quite punitive to taxpayers who had already built substantial savings inside of corporations, applying a 73% tax rate on income earned from those investments. After numerous submissions from the business, tax and accounting community, the Department of Finance later announced it would grandfather previously saved investments which would have introduced significant administrative burdens on taxpayers to track when investment funds had been accumulated.

What did *not* change in this budget?

Income tax rates

Capital gains inclusion rates

Capital gains exemption rules

Surplus stripping rules

Budget 2018 has instead introduced measures that will result in less of an administrative burden but will still impact taxpayers who hold investments in private corporations that earn active business income.

Business Limit Reduction

Canadian Controlled Private Corporations ("CCPC") are eligible to claim the small business deduction for active business income up to $500,000. Legislation is currently in place to reduce this $500,000 limit where a corporation is considered a large corporation. This limit must be shared by associated corporations.

Budget 2018 proposes to reduce the small business deduction limit in a given taxation year on a straight line basis where a CCPC has earned passive investment income. The reduction of this limit begins when the corporation earns $50,000 of investment income and will be fully reduced at $150,000 of investment income.

The effect of this reduction will be felt by CCPC's earning active income that is in excess of their reduced small business limit as they will pay tax on this income at the general business rate of 15%.

Finance has provided the following illustration of the remaining small business deduction based on the level of passive income reported

	Investment income				
Business Income	**$50,000**	**$75,000**	**$100,000**	**$125,000**	**$150,000**
$50,000	No impact				$0
$75,000					$0
$100,000					$0
$200,000				$125,000	$0
$300,000			$250,000	$125,000	$0
$400,000		$375,000	$250,000	$125,000	$0
$500,000		$375,000	$250,000	$125,000	$0

For example, a corporation earning $75,000 of active income and $100,000 of investment income, would not be impacted by this measure as their remaining small business deduction limit would still be in excess of their active income.

This reduction will operate alongside the reduction for large corporations and the larger of the two reductions will apply.

Capital gains and losses relating to the disposal of assets used in the active business or shares of a related active business will be exempt from the calculation of investment income for these purposes.

A holding corporation currently earning only passive income will not experience any change due to these measures as they would not have previously qualified for the small business deduction and will continue not to receive it.

Dividends and Refundable Dividend Tax on Hand ("RDTOH")

Currently when a corporation earns investment income, the corporation is subject to a higher tax rate on investment income. A portion of this investment tax is refundable when the corporation pays dividends to shareholders (who in turn pay tax personally on that dividend) and is tracked in the notional RDTOH account.

Proposed punitive tax rules on passive investments will be replaced with RDTOH limitations and small business limit reductions.

Dividends are subject to different tax rates depending on the tax rate that was applied to the corporation on that income. Eligible dividends are subject to a lower tax rate than non-eligible dividends. Eligible dividends are typically received as portfolio dividends from public corporations but can also be paid by private corporations from income that was taxed at the general corporate tax rate (where no small business deduction was applicable). Income would generally be taxed at the general corporate rate when active income is earned in excess of the $500,000 small business limit. Dividends paid from corporate retained earnings that were subject to the lower small business tax rate are consequently taxable at a higher rate to the individual shareholder and are classified as a non-eligible dividend.

These designations (eligible versus non-eligible) were previously unimportant when determining the refund that would be received by the corporation from the notional RDTOH account on the payment of a dividend. Department of finance has split this current account into two new accounts in an effort to ensure non-eligible dividends are paid (subject to higher tax than eligible dividends) to receive a refund of RDTOH that resulted from investment income.

Eligible RDTOH will track refundable tax that has been paid on the receipt of portfolio dividends. Any eligible or non-eligible dividend will entitle the corporation to a refund of this account.

Non-Eligible RDTOH will track refundable tax paid on investment income. Corporations will only receive a refund of this account when non-eligible dividends are paid to the shareholder.

A corporation will be required to receive a refund from its non-eligible account before it may access the eligible account.

This measure will be implemented for taxation years that begin after 2018 and the existing RDTOH balance will be allocated between the two accounts on a formulaic basis.

Anti-Avoidance

As the above measures related to passive investment income take effect for taxation years beginning after 2018, the government indicated that it intends to prevent attempts to effect a deemed short year end and achieve additional tax years.

Offshore Investments

Where a Canadian owns a significant interest in a foreign corporation that earns passive income, that income is included in the taxpayer's income in the year it is earned. This income is referred to as foreign accrual property income (FAPI). Where the foreign entity employs the equivalent of more than 5 full-time employees, this income is not considered FAPI. As a result, some taxpayers have engaged in planning to pool their assets offshore with other taxpayers, to warrant the required number of employees, generally with a tracking arrangement in place. As a result of this tracking arrangement, the assets contributed by unrelated individuals are not considered to be truly pooled as their overall economic outcome would remain unchanged. Budget 2018 has proposed changes to specific definitions to mitigate this tax planning.

Foreign Affiliate Reporting

Where Canadian corporations control foreign corporations, they are required to complete an information return called a T1134. The government has proposed that the due date for these returns be reduced from the current 15 months after year end to 6 months after year, coinciding with the T2 – Corporate Tax return filing deadline

Trust Measures

The 2018 budget is proposing new rules to increase the transparency of information related to trusts and has provided significant funds to Canada Revenue Agency to support the development of an electronic platform for processing T3 returns.

Under the current rules, a trust that does not earn income or make a distribution in a year is not required to file a T3 Trust Information Return. Even so, when the trust does file a return there is no requirement for the trust to report the identities of all those involved in the trust. Starting in 2017, the government began to increase the tax reporting requirements for trusts in an effort to retrieve this information.

The 2018 budget proposes that certain trusts will file annual returns when they otherwise wouldn't have in the past.

These new requirements will apply to express trusts resident in Canada and non-resident trusts that are currently required to file a T3 return. Pursuant to the 2018 budget the following trusts are exempt from the new reporting requirements

- Mutual fund trusts
- Trusts governed by registered plan (i.e registered retirement savings plans)
- Lawyers' general trust accounts;
- Graduated rate estates and qualified disability trusts;
- Trusts that qualify as non-profit organizations or registered charities
- New Trusts (less than three months) and small trusts that hold less than $50,000 in assets throughout the taxation year

Trusts subject to the new reporting requirement will be required to report the identity of all the trustees, beneficiaries and settlors of the trust, as well as the identity of each person who has the ability to exert control over trustee decisions regarding the appointment of income or capital of the trust.

These measures will apply to returns required to be filled for the 2021 and subsequent taxation years.

The 2018 budget proposes new penalties to support the new reporting requirements. The penalty will be equal to $25 per day of delinquency with a minimum penalty of $100 and a maximum of $2,500. If the failure to file was made knowingly or due to an additional penalty would apply equal to 5% of the maximum fair market value of property held by the trust, during the relevant tax year with a minimum penalty of $2,500.

Health and Welfare Trusts

A Health and Welfare Trust is a trust established by an employer for the purpose of providing health and welfare benefits to its employees.

The tax treatment of Health and Welfare Trusts is not included in the Income Tax Act, however, the CRA has published administrative positions regarding the taxation of these trusts. The Employee Life and Health trust rules were added to the Income Tax Act in 2010. As the rules are very similar to the CRA's position on Health and Welfare Trusts, going forward, only one set of rules will apply to these arrangements. CRA will no longer apply their administrative policy after 2020.

Trusts that do not convert to an Employee Life and Health Trust will be subject to the normal income tax rules for trusts. Any health and wellness trust set up after February 28, 2018 will not receive the treatment of CRA's administrative policy.

The CRA will announce transitional administrative guidance relating to windup up an existing Health and Welfare Trusts.

Personal Income Tax Measures

Donations to Universities Outside of Canada

Historically, donations to universities outside of Canada have been eligible for the donation tax credit so long as these universities can demonstrate that their student body ordinarily includes students from Canada. These qualifying universities outside of Canada are included in Schedule VIII to the income tax regulations. These universities were also required to register separately with the CRA. The 2018 budget proposes that these universities will no longer have to be listed in the Income Tax Regulations and will only be required to register with the CRA.

Canada Workers Benefit (Prev. The Working Income Tax Benefit)

This is a refundable tax credit intended to supplement the earnings of low-income workers. For 2019, the benefit will be equal to 26% of each dollar of earned income in excess of $3,000. The maximum benefit is equal to $1,355 for single individuals without dependents and $2,335 for families. The benefit will be reduced by 12% of adjusted net income in excess of $12,820 for single individuals without dependents and $12,829 for single individuals and $17,025 for families.

Individuals who are eligible for the Disability Tax Credit will receive the Canada Workers Benefit disability supplement. The 2018 budget proposes that the supplement will increase to a maximum of $700 in 2019. The phase-out threshold of the supplement will be increased to $24,111 for single individuals without dependents and to $36,483 for families.

The federal government allows for province-or territory-specific changes to the design of the benefit through reconfiguration agreements provided that certain principles are followed.

Historically, if an individual did not claim this benefit by completing schedule 6 on their tax return, they could not obtain the credit even if they would otherwise qualify. The 2018 budget proposes to allow the CRA to assess the returns of qualifying individuals as if the benefit had been claimed. However, it is expected that individuals continue to complete schedule 6 to accurately calculate their tax liability and to avoid delays in processing their tax return.

This measure will apply for income tax returns for 2019 and subsequent taxation years.

Extension of the Medical Expense Tax Credit

The medical expense tax credit (METC) is a 15% non-refundable tax credit intended to provide relief for those with above-average medical and disability related expenses. For 2018, the METC is available for qualifying medical expenses in excess of the lesser of $2,302 and 3% of the individual's net income.

Budget 2018 expands the eligible expenses in relation to service animals. Currently, only service animals specially trained to assist a patient in coping with the following impairments qualify: blindness; profound deafness; severe autism; severe diabetes; severe epilepsy; or a severe and prolonged impairment that markedly restricts the use of the patient's arms or legs.

This is expanded to also include services animals specially trained for patients with a severe mental impairment (ex. Post-traumatic stress disorder). Animals providing emotional support that have not been specially trained to perform certain tasks are not eligible.

This measure will apply in respect of eligible expenses incurred after 2017.

RDSP – Qualifying Plan Holders

Historically, where the capacity of an adult individual to enter into a contract is in doubt, the act requires that the plan holder of the individual's RDSP be the individual's legal representative. The government is of the position that establishing legal guardianship is expensive and can be a lengthy process as such, a temporary federal measure exists that allows a qualifying family member to be the plan holder of the individual's RDSP where the adult individual does not have a legal representative in place. Budget 2018 extends this until 2022 as opposed to having this expire in 2018.

Deductibility of Employee QPP Contributions

In 2016, the government announced an enhancement to the Canada Pension Plan (CPP). As such, the tax act was amended to include a tax deduction for employee contributions (and employer contributions for self-employed individuals) for the enhanced portion of the CPP. This will begin in 2019 and will be fully phased in by 2025.

To provide consistency between CPP and the Quebec Pension Plan (QPP) the 2018 budget proposes to amend the act to include a deduction for employee contribution (and employer contributions for self-employed individuals) to the enhanced portion of the QPP.

This measure will apply to the 2019 and subsequent taxation years.

Sales and Excise Tax Measures

Cannabis Taxation

The 2018 budget proposes a new federal excise duty for cannabis products. Cannabis cultivators and manufacturers will be required to obtain a license from Canada Revenue Agency and remit the excise duty. This will come into effect when recreational cannabis becomes available for legal retail sale.

The excise duties will be imposed on licensed producers at the higher of a flat rate and a percentage of the dutiable amount sold by the producer.

- The flat rate will be a dollar-per-gram, or dollar per seed/seedling basis. A lower rate per gram will be applied for trim as opposed to flower. The rate will be applied at the time of packaging for final retail sale which is considered to be when it is put in a container intended for sale to a final consumer at the retail level.
- The 10% of the dutiable amount is levied at the time of delivery of the product.

Cannabis will have an excise tax applied and will be sold in packaging colour coded by province.

The licensee who packaged the product is liable to pay the excise duty. All cannabis products are required to have an excise stamp. These stamps will have specific colors depending on the provincial or territorial market.

Products containing less than 0.3% of THC and products approved by Health Canada with a Drug Identification Number that can only be acquired through a prescription will not be subject to excise duty.

As part of the coordination between the Federal and provincial/territorial government, 75% of the taxation revenues will flow to participating provinces and territories with the remaining 25% flowing to the federal government. The federal portion is capped at $100M annually for the first two years with the remaining being distributed to the provinces.