2018 Federal Budget Review

On February 27, Finance Minister Bill Morneau unveiled the Liberal government's third Federal Budget entitled "Equality + Growth: A Strong Middle Class" which continues with many of the themes of previous budgets, including an undertaking of a gender-based analysis in developing any budget proposals. The Budget anticipates a deficit of $19.4 billion for fiscal 2017-18 and forecasts a deficit of $18.1 billion for 2018-19.

Consistent with previous years, notable themes of the Budget include innovation, gender equality – including the introduction of a new EI Parental Sharing Benefit – and tax fairness and integrity. With regards to the latter items, the Budget outlined the government's continued focus on eliminating perceived unfair tax advantages for some, cracking down on tax evasion, and measures to improve the efficiency, certainty and fairness of the tax system.

From a personal and small business tax perspective, which is the focus of this review, the Budget did not propose any changes to personal or corporate tax rates. Notably, as expected, the government introduced important changes to the tax treatment of passive income earned in Canadian private corporations. However, these changes to private corporations and their shareholders are simpler and more targeted than originally envisioned in the government's 2017 consultation paper and subsequent announcements. The personal tax measures proposed in the Budget were minor in comparison, consisting primarily of slight tweaks to existing specific tax credits.

The most significant income tax measures affecting individuals and Canadian private companies are summarized below. Note that the measures introduced are only proposals at this stage and may not ultimately be enacted into law. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.

Summary of Personal Income Tax Proposals

Canada Workers Benefit

The current Working Income Tax Benefit (WITB) is a refundable tax credit that supplements the earnings of low-income workers. Effective 2019, the Budget proposes to strengthen this program (to be renamed the Canada Workers Benefit (CWB)), by making it more generous, and making the benefit more accessible. To that end, the Budget also proposes to allow the Canada Revenue Agency (CRA), in circumstances where an individual does not claim the new CWB, to determine if the individual is eligible to receive the benefit and assess their return as if the benefit had been claimed.

Canada Pension Plan (CPP)/Quebec Pension Plan (QPP)

The Government of Quebec announced recently that the QPP would be enhanced in a manner similar to the enhancement of the CPP that was announced in 2016. As part of the CPP enhancement, the Income Tax Act (ITA) was amended to provide a tax deduction for employee contributions (as well as the "employee" share of contributions by self-employed persons) to the enhanced portion of the CPP, whereas a tax credit will continue to be provided on employee contributions to the base CPP (i.e., the existing CPP). Contributions to the enhanced portion of the CPP will begin in 2019 and will be fully phased in by 2025.

To provide consistent income tax treatment of CPP and QPP contributions, the Budget proposes to amend the ITA to provide a deduction for employee contributions (as well as the "employee" share of contributions made by self-employed persons) to the enhanced portion of the QPP, paralleling the deduction for the enhanced portion of employee QPP (and CPP) contributions for Quebec income tax purposes. This measure will apply for the 2019 and subsequent taxation years.

Other minor personal tax changes include the following:

- Expansion of the medical expense tax credit to include certain additional expenses after 2017 in respect of a specially trained animal to assist patients with severe medical impairments;

- Extension to 2023 of an existing temporary federal measure allowing a qualifying family member to be the plan holder of an RDSP for individuals with capacity issues; and
- A further extension of the eligibility for the mineral exploration tax credit for an additional year, to flow-through share agreements entered into on or before March 31, 2019.

Proposals Affecting Canadian Private Companies

Holding Passive Investments Inside a Private Corporation

A much anticipated tax measure expected in the 2018 Federal Budget was the release of detailed draft legislation affecting private corporations holding passive investments. Proposed measures, first introduced as part of a more comprehensive consultation paper released in July 2017, seek to limit the tax deferral advantage that can be achieved if after-tax profits of an active business are retained within a private corporation.

Active business income earned by private corporations is taxed at corporate income tax rates that are generally lower than personal income tax rates. In addition, a Canadian-controlled private corporation (CCPC) can benefit from a reduced corporate income tax rate (achieved through a small business deduction) on qualifying active business income that is lower than the general corporate income tax rate. Where funds invested passively within a private corporation have been financed with retained earnings that have been taxed at preferential corporate active business income tax rates, owners of the corporation can benefit from a tax deferral advantage relative to a situation where the corporation distributes its retained earnings and the owners invest personally in passive investments.

As part of these initial proposals, complex measures were contemplated to alter the taxation of corporate passive income and the refundable tax system under current tax legislation. In October 2017, the government provided an initial response after the consultation period intending that any changes made in the 2018 Budget would ensure that:

- Passive investments already made by private corporations' owners, including the future income earned from such investments, would not be impacted;
- Going forward, a $50,000 annual threshold on passive income would be available to provide more flexibility for business owners to hold savings for multiple purposes (equivalent to $1 million in passive investment assets at a 5 per cent return); and
- Incentives would be maintained such that Canada's venture capital and angel investors can continue to invest in the next generation of Canadian innovation.

In the course of consultations, the government heard that its proposals could be very complex and would add significant administrative burdens to Canadian businesses. In response to these concerns and consistent with its original outlined principles, the government proposed two new measures in the Budget to limit tax deferral advantages from holding passive investments in a corporation, but in a more targeted and simpler manner than was originally proposed in July 2017. These measures are as follows:

Business Limit Reduction

As noted above, small businesses benefit from a reduced federal corporate income tax rate of 10 per cent – a preference relative to the general federal corporate income tax rate of 15 per cent – on the first $500,000 per year of qualifying active business income of a CCPC (which is shared amongst associated CCPCs). Access to the lower tax rate is phased out on a straight-line basis for associated CCPCs having between $10 million and $15 million of aggregate taxable capital employed in Canada.

The first measure proposed in the Budget seeks to limit the ability of businesses with significant passive investments to benefit from this preferential small business tax rate. Rather than remove or alter access to the refundable taxes (on passive income earned in a CCPC) as originally proposed in July 2017, the alternative proposed approach outlined in the Budget will gradually reduce access to the small business tax rate for corporations that have significant passive investment income. As such, the Budget proposes to introduce an additional eligibility mechanism for the small business deduction, based on the level of the corporation's passive investment income.

Under the proposal, if a corporation and its associated corporations earn more than $50,000 of passive investment income in a given year, the amount of income eligible for the lower small business tax rate will be gradually reduced. Specifically, the Budget proposes that the small business deduction limit be reduced by $5 for every $1 of aggregate investment income above the $50,000 threshold, such that the business limit (of $500,000) would be reduced to zero at $150,000 of investment income.

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The $500,000 business limit reduction under this new measure will operate alongside the business limit reduction that applies in respect of taxable capital outlined above. In particular, the reduction in a corporation's business limit will be the greater of the reduction under this new measure and the existing reduction based on taxable capital. For the purpose of determining the reduction of the business limit under this additional method, investment income will be measured by a new concept of "adjusted aggregate investment income" which will be based on "aggregate investment income" (a concept that is currently used in computing the amount of refundable taxes in respect of a CCPC's investment income), with certain adjustments. Notably, dividends from non-connected corporations will be added whereas capital gains realized from the sale of active investments, investment income incidental to the business, and net capital losses applied from other taxation years will not be taken into account in the measurement of passive investment income for purposes of this calculation.

Limiting Access to Refundable Taxes

The second proposed measure will limit perceived tax advantages that some CCPCs can currently obtain by accessing refundable taxes on the distribution of certain dividends.

The tax system is designed to tax passive investment income earned by private corporations at a higher rate than active business income, roughly equivalent to the top personal income tax rate, and to refund a portion of that tax when investment income is paid out to shareholders as a dividend taxed personally.

Currently, however, any taxable dividends paid by a private corporation triggers a refund of taxes paid on investment income, regardless of the source of that dividend (i.e., whether derived from investment income or lower-taxed active business income). This means that larger CCPCs can pay out lower-taxed (eligible) dividends from their pool of active income taxed at the lower general corporate rate, and still claim a refund of taxes paid on their investment income distributed. As these amounts distributed are intended to be taxed at higher personal tax rates, a tax deferral advantage can arise.

To better align the refund of taxes paid on passive income with the payment of dividends sourced from passive income, the Budget proposes that a refund of the refundable tax will only be available where a private corporation pays (higher-taxed) non-eligible dividends. However, an exception will be provided in respect of refundable tax that arises from eligible portfolio dividends received by a corporation, such that the corporation will still be able to obtain a refund upon the payment of eligible dividends in these circumstances.

The two measures will apply to taxation years that begin after 2018 and anti-avoidance rules will apply to prevent transactions designed to avoid these measures. Transitional rules are proposed for existing refundable tax balances and tracking of separate refundable tax accounts will be required once implemented.

Other Notable Measures

Trusts – Expanded Reporting Requirements (Beneficial Ownership)

To improve the availability of beneficial ownership information (as a means to effectively counter aggressive tax avoidance, money laundering and other criminal activities), the Budget proposes to introduce enhanced income tax reporting requirements for certain trusts to provide additional information on an annual basis. The new reporting requirements will impose an obligation on certain trusts to file a T3 return where one does not currently exist, and to report the identity of all trustees, beneficiaries and settlors of the trust.

The new reporting requirements will apply to "express trusts" (i.e. generally a trust created with the settlor's express intent) that are resident in Canada and to non-resident trusts that are currently required to file a T3 return, with certain exceptions proposed for specific types of trusts.

These proposed new reporting requirements will apply to returns required to be filed for the 2021 and subsequent taxation years. To support these new reporting requirements, the Budget proposes to simultaneously introduce new penalties for a failure to file a T3 return, including a required beneficial ownership schedule, in circumstances where the new schedule is required. The penalty will be equal to $25 for each day of delinquency, with a minimum penalty of $100 and a maximum penalty of $2,500. Other existing, and proposed, penalties may also apply.

Health and Welfare Trusts

A Health and Welfare Trust (HWT) is a trust established by an employer for the purpose of providing health and welfare benefits to its employees. The tax treatment of these trusts is not explicitly set out in the ITA; instead the CRA has historically published administrative positions to provide guidance regarding the tax treatment of these arrangements.

Similar arrangements, defined as Employee Life and Health Trusts (ELHTs), also provide health benefits for employees – specifically, group sickness or accident insurance plans, private health services plans and group term life insurance policies. However, unlike HWTs, the ITA provides specific rules for ELHTs which are very similar to the CRA's administrative positions for HWTs, with additional clarification for certain issues not dealt with in the administrative regime for HWTs.

With the aim of providing more certainty for taxpayers and greater consistency in the tax treatment of such arrangements, the Budget proposes that only one set of rules apply to these arrangements. As such, the CRA will no longer apply their administrative positions with respect to HWTs after the end of 2020. To facilitate the conversion of existing HWTs to ELHTs, transitional rules will be added to the ITA. Trusts that do not convert (or wind up) to an ELHT will be subject to the normal income tax rules for trusts. In addition, the CRA will not apply its administrative positions relating to HWTs to trusts established after Budget Day and will announce transitional administrative guidance relating to winding up existing HWTs.

In this regard, stakeholders will be invited to submit comments by June 29, 2018 on transitional issues regarding the discontinuation of the HWT regime. Following this consultation, the government intends to release draft legislative proposals and transitional administrative guidance.

Integrity Measures

As in previous budgets, this Budget continues the government's efforts to make legislative adjustments to help ensure that the tax system is functioning as intended and introduces certain measures to maintain the integrity of the tax system by:

- Improving existing anti-avoidance rules meant to prevent a small group of taxpayers from gaining a tax advantage by creating artificial losses that can be used against other income through the use of sophisticated financial instruments and structured share repurchase transactions; and
- Clarifying the application of the "at-risk" rules for limited partnerships with a view to prevent taxpayers from obtaining unintended tax advantages through the use of complex (tiered) partnership structures.

Strengthening Canada's International Tax Rules

Consistent with prior years, the government has taken further steps in this Budget to strengthen the CRA's ability to crack down on tax evasion and combat tax avoidance, particularly as it relates to international transactions. Specifically, the Budget seeks to further combat aggressive international tax avoidance and strengthen Canada's international tax rules by introducing measures to:

- Ensure that these rules cannot be avoided through the use of certain "tracking arrangements" (which allow taxpayers to "track" to their specific benefit the return from assets that they contribute to a foreign resident corporation); and
- Implement comprehensive "look-through" rules to prevent unintended, tax-free distributions by Canadian corporations to non-resident shareholders through the use of certain transactions involving partnerships and trusts.

Similarly, given the complexity of audits that involve foreign affiliates and with the aim of ensuring that the CRA has an opportunity to properly examine all activities in respect of foreign affiliates that are relevant to the Canadian tax base, the Budget also proposes:

- To extend the reassessment period for a taxpayer by three years in respect of income arising in connection with a foreign affiliate of the taxpayer (effective for taxation years of a taxpayer that begin on or after Budget Day); and
- To make the information return deadline in respect of a taxpayer's foreign affiliates consistent with the taxpayer's income tax return deadline by requiring these (T1134) information returns to be filed within six months after the end of the taxpayer's taxation year (effective for taxation years that begin after 2019).

On a related note, proposals were also introduced to extend the CRA reassessment period in certain circumstances regarding a loss carryback involving a non-resident who does not deal at arm's length with the taxpayer.

Charitable Giving

There were very limited measures in the Budget impacting charitable giving. These include:

- A proposal to allow transfers of property to municipalities to potentially reduce the tax applied to a charity which has had its charitable status revoked; and
- Simplification of the administrative rules and process for universities outside Canada to register as a qualified donee.

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Previously–Announced Measures

The Budget confirms the government's intention to proceed with certain other previously announced tax and related measures, including the following measures affecting individuals and Canadian private companies:

- Measures announced on October 16, 2017 which lower the small business tax rate from 10.5 per cent to 10 per cent, effective January 1, 2018, and to 9 per cent, effective January 1, 2019, along with related amendments to the gross-up amount and dividend tax credit for taxable dividends; and
- Measures released on December 13, 2017 addressing income sprinkling.

Please see our publications entitled **Tax Proposals Affecting Private Corporations – Initial Government Response Following Consultation Period** and **Tax Proposals Affecting Private Corporations: "Income Sprinkling" Draft Legislation Revised** for more information regarding these important recent developments.

The **2018 Federal Budget Review** was developed by our in-house experts in the Enterprise Wealth Planning Group at BMO Wealth Management: **John Waters**, Vice-President, Director of Tax Consulting Services and **Dante Rossi**, Director, Tax Planning. For more insights, visit **bmo.com/wealthexchange**

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details.

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