TAXTALK

2018 FEDERAL BUDGET HIGHLIGHTS

On February 27, 2018, Federal Finance Minister Bill Morneau presented the 2018 Federal Budget entitled *"Equality and Growth"*.

The Federal Government's 2018 Budget includes tens of billions of dollars in new or increased spending over the next six years, with the goal of further growing government revenues by increasing economic participation among women, visible minority Canadians and persons with disabilities, as well as substantial long-term investments in science and technology.

The government suggests that increasing equality for women and enhancing women's participation in the workplace (especially in technology and trades) could add $150 billion to the Canadian economy over the next decade.

Highlights from the Federal Budget include:

- Reducing the federal small business tax rate to 10% effective January 1, 2018 and 9% as of January 1, 2019
- Reducing access to the small business tax rate for businesses with high passive investment income (expected to apply for year-ends starting in 2019)
- Extending eligibility for accelerated capital cost allowance for certain clean energy equipment
- Annual indexation of the Canada Child Benefit (starting July 1, 2018)
- "Use it or lose it" EI parental benefits (expected availability June 2019)
- Applying GST/HST to management and administrative services provided to an investment limited partnership by the general partner (after September 8, 2017)
- Pre-apprenticeship assistance for underrepresented groups (starting 2018–19)
- Additional reporting requirements for trusts (effective 2021 tax year)

BUSINESS TAX MEASURES

The Budget makes no changes to corporate tax rates except for the reduction in the Small Business Tax Rates previously announced.

Passive Investment Income Earned by Private Corporations

The Budget proposes to introduce measures to reduce perceived tax advantages where a private corporation earns passive income. The announcement that such measures were going to be introduced was first made on July 18, 2017, along with other substantive measures intended to reduce the ability of taxpayers to sprinkle income among family members. The Budget proposals bear little resemblance to the measures initially announced and introduce a simplified approach to address the tax deferral advantages in accumulating surplus savings in a private corporation.

The Budget proposes two sets of new provisions. One set is intended to reduce the $500,000 business limit otherwise available to a group of associated Canadian-controlled private corporations (CCPCs) where the group earns a significant amount of passive income. The second set reduces, but does not eliminate, the ability of a corporation to obtain refunds of refundable dividend tax on hand (RDTOH) by paying eligible dividends as compared to non-eligible dividends.

Limiting Access to the Small Business Tax Rate

The business limit of an associated group of CCPCs is already reduced where the group's "taxable capital employed in Canada" exceeds $10,000,000.

The proposed provisions will reduce the group's business limit on a straight-line basis where the group earns "adjusted aggregate investment income" (AAII) between $50,000 and $150,000. The reduction will be $5 for every $1 of investment income. Consequently, a group's business limit will be reduced to zero (5 × $100,000 = $500,000) in a particular year if its adjusted aggregate investment income is $150,000 or more.

Generally, the AAII will exclude taxable capital gains from the sale of active investments (i.e. business assets), capital gains from the sale of shares of a connected CCPC and investment income that is incidental to the business. These exclusions from AAII are intended to address concerns regarding the encouragement of venture capital and angel investors in Canadian innovation.

This reduction to the business limit is based on income for the year that ended in the preceding calendar year.

This proposal will apply to taxation years that commence after 2018 with no grandfathering of passive income earned on existing investments. Consequently, all future investment earnings will be included in this annual test, regardless of when the applicable investments were accumulated.

The reduction of a corporation's business limit for a particular year will be equal to the greater of the reduction under the existing taxable capital rule and the proposed rule.

Anti-avoidance measures will discourage transactions designed to delay or avoid the new rules. One such transaction might otherwise have been the creation of a short taxation year. Another might have been the transfer of property to a related but unassociated corporation.

Limiting Access to Refundable Tax

The Budget proposes to limit certain tax advantages that can be obtained by CCPCs to access refundable taxes on the distribution of certain dividends. Currently, a corporation can receive RDTOH refund upon paying an eligible dividend. The Budget proposes to only allow a refund of RDTOH where a private corporation pays non-eligible dividends.

An exception will be provided in respect of RDTOH that arises from eligible portfolio dividends received by a corporation, in which case the corporation will still be able to obtain a refund of that RDTOH upon the payment of eligible dividends.

For reference, a corporation's ability to pay an eligible dividend depends on its status. A CCPC can only pay an eligible dividend to the extent that it has a balance in its "general rate income pool" (GRIP) at the end of the taxation year in which the dividend is paid. The GRIP generally reflects

taxable income that has not benefited from preferential small business tax rates. Individuals receiving non-eligible dividends (or regular dividends) are taxed at a higher rate versus receiving eligible dividends.

The Budget proposes to create an "eligible RDTOH" account and a "non-eligible RDTOH" account. Eligible RDTOH will include only Part IV tax paid on the receipt of eligible portfolio dividends. All other RDTOH will be included in the non-eligible RDTOH account.

If a corporation pays a non-eligible dividend, it recoups non-eligible RDTOH before it recoups eligible RDTOH. If it pays an eligible dividend, it can recoup eligible RDTOH. Any taxable dividend paid, either eligible or non-eligible, will entitle the corporation to a refund of eligible RDTOH.

On transition to these new rules, the existing RDTOH of a CCPC will first be allocated to its eligible RDTOH account to a maximum of 38 1/3% of its general rate income pool (GRIP). The remainder, if any, of its existing RDTOH balance will be allocated to its non-eligible RDTOH account. All of the existing RDTOH of other corporations will be allocated to their eligible RDTOH account.

This measure will apply to taxation years that commence after 2018. An anti-avoidance measure will prevent the deferral of the new measures by creating a short taxation year.

Income Sprinkling Measures

Overview

The Budget confirms that Finance will proceed with the implementation of the December 13, 2017, draft proposals that address income sprinkling involving private corporations.

The amended rules will apply to the 2018 and subsequent taxation years and will clarify the process for determining whether a family member makes contributions to a business, and thus is excluded from potentially being taxed at the highest marginal tax rate on amounts derived from the business (known as the tax on split income (TOSI)).

Finance has once again confirmed that the TOSI rules will not apply to limit the lifetime capital gains exemption (LCGE) and notes that these measures will be legislated as part of this Budget.

The TOSI regime that existed prior to 2018 (commonly referred to as the "kiddie tax" rules), eliminated any benefit of splitting income with minors.

The new TOSI rules contain an extensive series of changes that significantly widened the application of the TOSI rules. By extending the age of the individuals affected and expanding the definition of "split income", the proposals made the rules applicable in a broader range of circumstances and adversely affected family income planning for private company shareholders.

The TOSI rules will potentially apply to essentially any income, dividends and capital gains received from a related business, known as "split income." This generally includes the following:

- Dividends and shareholder benefits from a private company;
- Income received from a partnership or trust where the income was derived from a related business;
- Interest or certain debt obligations; and
- Income or gains from the disposition of certain property associated with a related business.

Exclusions

Several exclusions from TOSI must be considered in order to determine if the tax applies. No adult of any age is subject to TOSI on income from an unrelated business. Also, the proposals introduce some "bright line" tests as well as a general reasonableness test that could operate to exclude an individual from the new TOSI rules. These tests are not mutually exclusive and vary based on the age of the individual in question.

An adult of any age will not be subject to TOSI on income derived from an "excluded business", i.e., one in which the individual is actively engaged on a "regular, continuous and substantial basis" in the taxation year in which the income amount is received, or in any five previous taxation years that need not be consecutive. This generally requires that the adult work in the business for at least an average of 20 hours per week during the part of the year that the business operates. However, if this 20-hour threshold is not met, it would be a question of fact whether or not the individual is actively engaged in the business on a regular, continuous and substantial basis.

Income derived by adults over the age of 24 from "excluded shares" is not subject to TOSI. To meet the definition of an excluded share, several conditions must be met.

- The individual in question must directly own at least 10% of the votes and value of the corporation.
- The corporation must earn less than 90% of its income from the provision of services.
- The corporation cannot be a professional corporation, such as those carried on by medical doctors, dentists, accountants, lawyers, chiropractors and veterinarians.
- All or substantially all of the corporation's income cannot be derived from a related business in respect of the individual.

If taxpayers restructure their corporations in order to meet the excluded share definition by the end of 2018, this exception will be available to them for the entire 2018 taxation year. Taxpayers and their advisors may want to pay particular attention to this exclusion when setting up a new corporation or undergoing a traditional estate freeze, as it is conceivable that it may be relied upon heavily in these contexts.

For example, if an amount is received in 2018, and at the time of receipt the taxpayer does not own 10% of the votes and values of the company, the amount received would not be considered split income (so that TOSI doesn't apply) in 2018 if the taxpayer increases their ownership to 10% by the end of 2018.

There are various exclusions for inherited property.

Taxable capital gains arising from the deemed disposition on the death of an individual as well as income derived from property acquired on the breakdown of a marriage or common-law partnership are also excluded from TOSI.

If none of the above exclusions from the TOSI rules apply, the reasonableness tests must be considered. This is because only income in excess of a "reasonable return" will be subject to TOSI.

For adults over the age of 24, a reasonable return will take into account various factors, including labour contributions, property contributions, risk assumed, historical payments, and any other relevant factors. As these factors do not include any thresholds in terms of hours worked or amounts contributed, there is a high degree of subjectivity with this test.

For adults between the ages of 18 and 24, what is considered to be a reasonable return is more precisely defined, but greatly limited. Only capital contributed will be considered.

Tax Support for Clean Energy

Capital cost allowance (CCA) Classes 43.1 and 43.2 provide accelerated CCA rates for investments in specified clean energy generation and conservation equipment. Class 43.2 was introduced in 2005 and is currently available in respect of property acquired before 2020. The Budget proposes to extend eligibility for Class 43.2 by five years to include property acquired before 2025.

U.S. Tax Reform

The Budget does not address U.S. tax reform other than to say that Finance will conduct a detailed analysis of the U.S. federal tax reforms to assess any potential impacts on Canada.

PERSONAL TAX MEASURES

The Budget did not propose any changes to the personal tax rates, however, effective for January 1, 2018, the top-marginal tax rate for non-eligible dividends will increase from 45.30% to 46.84% as a result of the reduction the change to the small business tax rate change. The combined federal and Ontario top-marginal personal tax rates for 2018 are:

Type of Income	Income Over $220,000
Eligible dividends	39.34%
Non-eligible dividends	46.84%
Capital gains	26.76%
Salary and other income	53.53%

Medical Expense Tax Credit (METC) — Service Animals

The METC is currently available in respect of expenses incurred for a service animal specially trained to assist an individual in coping with blindness, profound deafness, severe diabetes, severe epilepsy, severe autism or a severe and prolonged impairment that markedly restricts the use of the individual's arms or legs. The Budget proposes to extend the METC to expenses for animals specially trained to perform tasks for an individual with a severe mental impairment. An example is a psychiatric service dog trained to assist an individual with post-traumatic stress disorder.

Expenses for animals that provide comfort or emotional support, but are not specially trained, will not qualify. Qualifying expenses include the cost of the animal, costs for care and maintenance such as food and veterinary care, and costs for training the individual in handling the animal. This measure will apply in respect of expenses incurred after 2017.

Registered Disability Savings Plans (RDSP)

The plan holder of a RDSP must be the individual's legal representative where the capacity of the individual to enter into a contract is in doubt, for example, where the individual has a cognitive disability. Since the appointment of a legal representative can take a long time, a temporary federal measure allows a qualifying family member (parents, spouses and common-law partners) to be the plan holder of an individual's RDSP, if the adult individual does not have a legal representative. This provision was to expire at the end of 2018. The Budget extends it to the end of 2023. If a family member becomes a plan holder before the end of 2023, they will be able to continue as the plan holder after 2023.

Child Benefits

Foreign-born Status Indians who legally reside in Canada but are neither Canadian citizens nor permanent residents are eligible for the Canada Child Benefit (CCB), provided all other eligibility requirements are met. The Budget proposes to make them retroactively eligible for the Canada Child Tax Benefit, the National Child Benefit supplement and the Universal Child Care Benefit, the predecessors to the current CCB.

The Budget also proposes to provide authority for the federal government to share taxpayer CCB information with the provinces for the purpose of administering their social assistance payment regimes. This measure is effective July 1, 2018.

Employment Insurance Parental Sharing Benefit

The Budget proposes a new five-week Employment Insurance Parental Sharing Benefit, effective June 2019. This benefit will be available as a top-up in situations where both parents agree to share parental leave. It will be available to eligible two-parent families, including same sex-couples and adoptive parents. This new benefit is intended to provide greater flexibility, particularly for mothers, to return to work sooner.

Apprenticeship Incentive Grant for Women

Current legislation provides for the Apprenticeship Completion Grant which is a one-time taxable cash grant of $2,000 to a registered apprentice who has completed their apprenticeship training and obtains their journeyperson certification. The Budget proposes a new Apprenticeship Incentive Grant for Women. Under this program, women in male-dominated Red Seal trades will be able to receive $3,000 per year for each of their first two years of training. Nearly 90% of Red Seal trades would be eligible, according to the Budget documents. Presumably this grant would be taxable, but this is not clear from the budget documents.

For reference, over the years the Red Seal has become a nationally-recognized standard for skilled trades workers in Canada. Trades approved for Red Seal status are called “Red Seal Trades”.

INTERNATIONAL TAX MEASURES

In broad terms, foreign accrual property income (FAPI) is passive income earned by a “foreign affiliate” of a Canadian resident. FAPI is taxed on the accrual basis to the Canadian shareholder of a “controlled foreign affiliate.” If earned by a non-controlled foreign affiliate, it is not taxed in Canada on the accrual basis, but is taxable when repatriated to Canada.

Foreign-source income that would otherwise be treated as passive would, in certain circumstances, be considered to be active where the entity earning the income employs more than five employees (or the equivalent thereof), full-time in the active conduct of the business.

Investment Business

The Budget introduced a rule for the purposes of the investment business definition so that, where income attributable to specific activities carried out by a foreign affiliate accrues to the benefit of a specific taxpayer under a tracking arrangement, those activities carried out to earn such income will be deemed to be a separate business carried on by the affiliate. This will require each separate business of the affiliate to satisfy each relevant condition in the investment business definition, including the five employee test, in order for the affiliate’s income from that business to be excluded from FAPI.

Controlled Foreign Affiliate Status

The Budget also proposes to introduce measures that are intended to prevent the avoidance of controlled foreign affiliate status by the use of tracked pooling arrangements similar to those described above where the individual Canadian taxpayer does not participate in a controlling interest in the foreign affiliate. Under the tracking arrangement each taxpayer retains control over its contributed assets and any returns from those assets accrue to it benefit. This proposal would deem a foreign affiliate of a taxpayer in this type of scenario to be a controlled foreign affiliate.

These measures will apply to taxation years of foreign affiliates that begin on or after February 27, 2018.

Reassessment Period

The Budget proposes to extend the normal four-year reassessment period that is generally applicable to income arising from a taxpayer's foreign affiliate by three years. The extended reassessment period will now coincide with that available to the CRA in connection with transactions between Canadian residents and non-arm's-length non-residents.

This measure will apply to taxation years that begin on or after Budget Day.

Where a taxpayer has transactions with a non-arm's length non-resident, because the normal reassessment period available to the CRA is extended three years, there are circumstances that can prevent the CRA from reassessing a now statute-barred earlier year to which a taxpayer has carried back a loss.

The Budget proposes to allow the CRA an additional three years to reduce a loss carried back to a prior taxation year to the extent that the reassessment involves the adjustment, in a later year, of the loss carry back.

This measure will apply where the loss is carried back from a taxation year that ends on or after Budget Day.

T1134 Reporting Requirements

The Budget proposes to shorten the filing deadline for the foreign affiliate information reporting (T1134) from the current 15 months after the Canadian company's year-end to six months after the year-end to coincide with the filing deadline for the corporate tax return (T2).

This proposal applies to taxation years that begin after 2019.

TRUST TAX MEASURES

Reporting Requirements

The Budget proposes extensive new reporting requirements for most family trusts, effective for returns required to be filed for 2021 and subsequent taxation years. These requirements could impose an obligation to file a return where none currently exists, such as where the trust earned no income in the year. The trust will be required to report the identity of all trustees, beneficiaries and settlors of the trust. In addition, the identity of each person who has the ability to exert control, through the trust terms or a related agreement, over trustee decisions in respect of the appointment of income or capital must be disclosed.

The reporting requirements will apply to Canadian-resident trusts and to non-resident trusts currently required to file a Canadian return. This would include most personal "family" trusts used in tax planning. The following trusts are excluded from the requirements:

- Mutual fund trusts, segregated funds and master trusts
- Trusts governed by registered plans such as RRSPs
- Lawyers' general trust accounts
- Graduated rate estates (generally the first 36 months of a deceased individual's estate)
- Qualified disability trusts
- Trusts that qualify as registered charities or non-profit organizations
- Trusts in existence for less than three months
- Trusts that hold less than $50,000 in assets throughout the year as long as the assets are deposits, government debt obligations and/or listed securities; the Budget documents do not indicate if the $50,000 is based on cost or fair market value

These new reporting requirements are designed to provide better beneficial ownership information.

The Budget also introduces penalties for failure to file a trust return where the new reporting requirements apply. The penalty will be $25 per day late with a minimum of $100 and a maximum of $2,500. If the failure to file is made knowingly, or as a result of gross negligence, there will be an additional penalty of 5% of the maximum fair market value of property held during the year with a minimum of $2,500.

SALES TAX AND EXCISE TAX MEASURES

GST/HST and Investment Limited Partnerships

The Budget confirms the Federal Government's intention to proceed with the legislative and regulatory proposals released on September 8, 2017, relating to the application of GST/HST to investment limited partnerships with the following modifications:

- GST/HST only applies to management and administrative services rendered by the general partner on or after September 8, 2017, and not before this date unless the general partner has charged the GST/HST in respect of such services before that date
- GST/HST will generally be payable on the fair market value of the management and administrative services in the period in which they are provided
- An investment limited partnership will have the ability to make an election to advance the application of these rules as of January 1, 2018

Consultation on the GST/HST Holding Corporation Rules

The government intends to consult on the application of the "holding corporation rule" that allows a parent corporation to claim input tax credits to recover GST/HST paid on expenses that can reasonably be regarded as relating to the ownership of shares or indebtedness of a related commercial operating corporation.

The consultations will address the limitation of the rule to corporations and not other entities and the degree of relationship between the parent corporation and the commercial operating corporation.

The government intends on clarifying the expenses of the parent corporation that are in respect of shares or indebtedness of a related commercial operating corporation that qualify for input tax credits under this rule.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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