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TAXSTRATEGY

The 2018 Budget

A Relief

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The 2018 Federal Budget was highly anticipated (or perhaps, dreaded, in light of the flurry of announcements in 2017). Most of the drama surrounding the Budget release centered on one item: the passive income rules for private corporations as previously announced (and amended). Of course, tax practitioners were also arming themselves for other big hits that might come their way. For me, I armed myself with my traditional Budget Day cupcakes that I bring to the office – I figure that if they're going to hit us with something bad, then at least our tax department can console itself with some sugar.

Well, it turns out that Budget Day was pretty sweet, and not just because of my cupcakes. In fact, it was a sigh of relief that I let out while reading the Budget papers, as the anticipated changes were not as onerous as we thought. Some of the key highlights on the income tax aspects of the Budget are summarized below.

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Corporate Tax Measures

Passive Income Rules

You'll recall that in my previous articles summarizing the proposed changes affecting private companies, the last word from the Department of Finance as it related to the passive income rules was that the 2018 Budget would contain legislation on how they would be applied. As a reminder, the principles as previously announced were aimed to address the tax deferral advantages of accumulating passive assets in a private corporation and being able to take advantage of lower corporate tax rates. As such, the July 2017 proposals suggested applying the top corporate tax rate (50.17 per cent for Ontario) on passive income, subject to the following modifications:

1. Any past and current investments (and future income earned thereon) in a corporation as at the date the new rules (i.e. Budget date) are announced will be grandfathered, and so will not be subject to the new rules.

2. The first $50,000 of passive income will not be taxed at the top rates.

3. They will allow for contingency funds or reserves to allow for the purchase of equipment, business expansion or hiring and training of staff.

4. Incentives will be in place for venture capital and angel investors to allow them to continue to invest in Canadian innovation.

Happily, the 2018 Budget proposal substantially scaled back the previously announced measures, so much so that they seemed to be completely new rules. Essentially, the Budget proposed a clawback of the small business deduction instead of the application of the top tax rate.

Specifically, the small business deduction (SBD) limit for Canadian-controlled private corporations (CCPCs) (and associated corporations) would be reduced on a straight-line basis for CCPCs that have between $50,000 and $150,000 of investment income. The budget reduces the SBD by $5.00 for every $1.00 of investment income over the $50,000 threshold (the safe harbor amount previously announced in October 2017). Therefore, the SBD would be eliminated once a corporation reaches $150,000 a year.

The new rules will work in tandem with the taxable capital rules (where the SBD is reduced and eventually eliminated for companies that have taxable capital between $10 million and $15 million). Therefore, the reduction in a corporation's SBD limit will be the greater of the reduction under the new passive-income rules and the existing taxable capital-reduction rules.

As part of these new rules, the concept of "adjusted aggregate investment income" (AAII) was introduced to measure investment income. Generally speaking, the AAII will exclude taxable capital gains (and net capital losses) from the sale of active investments and investment income that is incidental to the business (this is meant to appease venture capital and angel investors). However, dividends from non-connected corporations will be added to AAII.

So, the key takeaway from these rules is that a CCPC might lose its SBD, but any investment income will still be taxed at the general corporate rate (26.5 per cent for Ontario) rather than at the top corporate rate. In the end, these proposals are definitely a welcome change (and deserve a red velvet cupcake!).

Refundable Dividend Tax on Hand (RDTOH) Regime

For CCPCs, the access to RDTOH on the payment of taxable dividends to its shareholders is a true cornerstone of tax integration for corporations and their shareholders. Currently, a CCPC will receive RDTOH refunds when paying a dividend, whether an eligible dividend (which is taxed in the hands of the recipient at lower dividend rates and are generally a result of high corporate tax being paid by the CCPC) or an ineligible dividend (which is taxed in the hands of the recipient at higher dividend rates, and which are generally a result of low corporate tax being paid by the CCPC).

The Budget introduces "eligible" and "non-eligible" RDTOH accounts. Under this new two-tiered system, if a corporation pays an eligible dividend it can only access the RDTOH refund to the extent of its eligible RDTOH account. If a corporation pays a non-eligible dividend, it must first recoup the non-eligible RDTOH first. Once that is exhausted, it will then get access to the eligible RDTOH.

The eligible RDTOH account will only include Part IV tax paid on the receipt of eligible dividends from non-connected corporations, and Part IV tax paid on dividends received from a connected corporation, to the extent of its proportionate share of the connected corporation's dividend refund arising from its eligible RDTOH account. The current RDTOH account will be redefined as the non-eligible RDTOH, and will track Part I refundable taxes.

Transitional rules were also announced for existing RDTOH balances: the lesser of the existing RDTOH balance and 38 1/3 per cent of the GRIP balance will be allocated to the eligible RDTOH for CCPCs.

Corporate tax rates

Although there were no new changes proposed to the corporate tax rates, the Budget confirmed the previously announced reduction in the federal SBD: a reduction to 10 per cent for 2018, and a further reduction to 9 per cent for 2019.

Miscellaneous Business Measures

✔ The Budget clarified that the at-risk rules for limited partnerships would apply at each level of a tiered-partnership structure. The current at-risk rules provide that a limited partner may deduct their share of a partnership's losses only to the extent of their at-risk amount (being their invested capital that is at risk in the partnership).

✔ Legislation was also introduced to clarify certain aspects of the synthetic equity arrangement rules and the securities lending arrangement rules to prevent taxpayers from realizing artificial tax losses through the use of equity-based financial arrangements.

✔ The Budget also amended the dividend stop-loss rule to decrease the tax loss on a repurchase of shares held as mark-to-market property, where it receives a tax deductible intercorporate deemed dividend on the repurchase.

✔ The Health and Welfare Trust tax regime (which has been based on an administrative position published by the CRA) is to be discontinued; transitional rules have been announced to facilitate the conversion of such trusts into Employee Life and Health Trusts, which are governed by specific rules under the Tax Act, so as to provide for one set of rules.

Personal Tax Measures

Reporting Requirements for Trusts

For 2021 and subsequent tax years, additional information will be required on trust tax returns (for both domestic and non-resident trusts). Specifically, disclosure is to be made for all trustees, beneficiaries and settlors (including anyone who is able to exert control over trustee decisions in relation to allocations of trust income or capital, such as a Protector). Certain trusts are excluded, including graduated rate estates, qualified disability trusts, non-profit trusts and registered charities or trusts that are less than three months old or that generally hold less than $50,000 worth in assets throughout the year.

New penalties will be introduced for failure to file a T3 with such information ($25 a day with a minimum of $100 and a maximum of $2500). If the failure to file was made knowingly or due to gross negligence, there is an additional penalty of 5 per cent of the maximum fair market value of the property held (with a minimum penalty of $2500).

Tax Credits/Deductions:

Although no changes were announced to the personal tax rates, the following tax credits were announced:

✔ Medical expense tax credit: the list of eligible expenses has been expanded to include a variety of expenses relating to service animals for patients with severe mental impairment (i.e. PTSD).

✔ Mineral exploration credit: this credit will be extended to flow-through share agreements entered into on or before March 31, 2019 (this was scheduled to expire on March 31, 2018).

Miscellaneous Personal Tax Measures:

✔ Canada Workers Benefit: This enhances the currently named Working Income Tax Benefit, which is intended to improve work incentives for low-income Canadians for the 2019 year and onwards. The maximum benefit will be increased by $170 to $1,355 for individuals without dependents and $2,335 for families). Additionally, the disability supplement will be increased to $700 for 2019. The benefit will be reduced for single individuals with income in excess of $12,820 and families with income over $17,025 (and fully eliminated for income at $24,111 for individuals and $36,483 for families). The benefit can be determined even when not specifically claimed.

✔ Registered Disability Savings Plan (RDSP): Currently, there is a temporary measure to permit certain family members (parents, spouses or common-law partners) to be the plan holder of an RDSP. This is set to expire at the end of 2018. The Budget has extended this measure to the end of 2023, and if a qualifying member becomes a plan holder before such date, they can remain as the plan holder after 2023.

✔ Child benefits: Foreign-born status Indians residing legally in Canada (who are neither Canadian citizens nor permanent residents) will be allowed to be retroactively eligible for the Canada Child Tax Benefit (for 2005 to June 30, 2016). This Benefit was replaced by the Canada Child Benefit introduced in 2016 (for which such persons were eligible). The Budget also provided for legislative authority to the federal government to share taxpayer information relating to this Benefit with the provinces and territories as of July 1, 2018.

Charities

Currently, upon the revocation of the registration of a charity (whether voluntary or not), a 100 per cent revocation tax is applied to the charity based on the total net value of its assets (which can be reduced by the making of qualifying expenditures). Under the Budget, transfers of properties to municipalities will not be qualifying expenditures, subject to case-by-case approval.

Additionally, donations to a university outside of Canada can be eligible for a charitable donation credit, even if the university is not listed in the Income Tax Regulations. Both measures are effective February 27, 2018.

International Tax Measures

Cross-border surplus stripping

Currently, there are cross-border anti-surplus stripping rules that seek to prevent non-residents from obtaining a tax benefit through a transfer of the shares of one Canadian corporation to another Canadian corporation that does not deal at arm's length with the non-resident, in exchange for shares of the purchasing Canadian corporation. The Budget includes some comprehensive look-through rules where taxpayers attempt to use partnerships as an intermediary as part of the transfer, such that the assets, liabilities and transactions of a partnership and trust will be allocated to its members or beneficiaries based on the relative fair market value of their interests.

Controlled foreign affiliate status

Currently, passive income of a foreign company controlled by a Canadian (a Controlled Foreign affiliate), referred to as FAPI, will be included in the income of the Canadian taxpayer on an accrual basis. The Budget proposes to deem a foreign affiliate to be a controlled foreign affiliate where there is a tracking arrangement in place allowing a taxpayer to retain control over its assets and any returns thereon. Such arrangements have been used to avoid the controlled affiliate status.

Foreign affiliate – Investment business

The Budget proposes to curtail the ability of taxpayers to make use of the more than five-full time employee exception to the FAPI rules where they enter into a tracking arrangement to pool their investment activities into one, common foreign affiliate. The Budget proposes to treat each of the activities carried out by foreign affiliate in such tracking arrangements as separate businesses, with each business having to meet its own separate test as it relates to the more than five full time employees.

Foreign affiliate reporting

Information returns for foreign affiliates (Form T1134) must now be filed within 6 months of a taxpayer's year-end (shortened from 15 months). This measure will apply for the taxation years beginning after 2019. ❏