February 27, 2018

2018 FEDERAL BUDGET

On February 27, 2018, Finance Minister Bill Morneau tabled the Liberal Government's 2018 Federal Budget. Read below for full tax highlights proposed or click on one of the Quick Links below.

QUICK LINKS

BUSINESS INCOME TAX MEASURES

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.

The Budget proposes two sets of new provisions. One set is intended to reduce the $500,000 small business limit otherwise available to a Canadian-controlled private corporation (CCPC), together with any associated CCPCs, where a significant amount of passive income is earned. 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.

$500,000 Business Limit Reduction

The small business limit of an associated group of CCPCs is currently 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" 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.

A group's "adjusted aggregate investment income" for the year will be based on "aggregate investment income", as currently defined, and is subject to the following adjustments:

- Dividends from non-connected corporations will be added.
- Taxable capital gains will be excluded to the extent that they arise from the disposition of assets used principally in an active business carried on primarily in Canada by the CCPC or a related CCPC.
- Taxable capital gains will also be excluded to the extent that they arise from the disposition of shares of a connected CCPC where all or substantially all of the fair market value of the assets of the connected CCPC is attributable to assets that are used principally in an active business carried on primarily in Canada.
- Net capital losses carried over from other taxation years will be excluded.
- Income from savings in a life insurance policy that is not an "exempt policy" will be added to the extent it is not otherwise included in aggregate investment income.

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.

Changes to RDTOH

Currently, a dividend refund is available to a corporation at the rate of 38 1/3 per cent of taxable dividends paid to the extent that there is an available balance of RDTOH at the corporation's year-end. The taxable dividends paid can be either non-eligible dividends or eligible dividends. There is a personal income tax advantage where eligible dividends are paid to obtain a dividend refund.

The Budget proposes to introduce measures that will generally allow a CCPC to recoup certain RDTOH only on the payment of non-eligible dividends. An exception will apply to RDTOH arising on the payment of Part IV tax on eligible portfolio dividends. Such RDTOH can be recouped on the payment of eligible or non-eligible dividends.

To accomplish this, the Budget proposes to create an "eligible RDTOH" account and a "non-eligible RDTOH" account. As indicated above, 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 only eligible RDTOH.

The existing RDTOH of a CCPC will first be allocated to its eligible RDTOH account to a maximum of 38 1/3 per cent 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

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

Please refer to our tax update published on December 15, 2017 for additional details in respect of income sprinkling measures. Read full article here →

AT-RISK RULES FOR TIERED PARTNERSHIPS

In response to a recent Federal Court of Appeal decision, the Budget proposes to restrict the allocation of losses to members of a top-tier partnership in tiered partnership structures. The allocable losses of a second-tier partnership will be restricted by the at-risk amount of the top-tier partnership, and unused losses will not be eligible to be carried forward. Rather, such unused losses will be added to the adjusted cost base of the top-tier partner's partnership interest in the second-tier partnership.

This measure will apply for taxation years that end on or after February 27, 2018, including restricting the use of losses carried forward from tax years that ended prior to that date.

TAX SUPPORT FOR CLEAN ENERGY

Capital cost allowance (CCA) Class 43.2 provides an accelerated 50 per cent CCA rate on a declining-balance basis 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.

ARTIFICIAL LOSSES USING EQUITY-BASED FINANCIAL ARRANGEMENTS

A corporation can generally deduct dividends received on a share of a corporation resident in Canada (a "Canadian share"). However, the current "dividend rental arrangement" rules deny this deduction where the main reason for an arrangement is to enable the taxpayer to receive a dividend on a Canadian share, and the risk of loss or opportunity for gain or profit accrues to someone else.

The Government is concerned that certain taxpayers are still engaging in abusive arrangements that are intended to circumvent the dividend rental arrangement rules and result in an artificial tax loss on the arrangement. Consequently, the Budget proposes an amendment which broadens the dividend rental arrangement rules and securities lending arrangement rules to prevent taxpayers from claiming a deduction for inter-corporate dividends received in situations where substantially all of the opportunity for gain or profit or risk of loss in respect of a Canadian share rests with certain persons other than the taxpayer. Similar rules are proposed to clarify situations in which a dividend compensation payment can be deducted.

These proposed rules are generally effective for dividends paid, or dividend compensation payments made, on or after February 27, 2018.

STOP-LOSS RULE ON SHARE REPURCHASE TRANSACTIONS

The Budget proposes an amendment to the dividend stop-loss rule to decrease the tax loss on a repurchase of shares held by the taxpayer as mark-to-market property where it receives a tax deductible inter-corporate dividend on the repurchase. This amendment generally reduces the tax loss by the full amount of the deemed dividend.

This proposal will apply to share repurchases occurring on or after February 27, 2018.

HEALTH AND WELFARE TRUSTS (HWT)

An HWT is a trust established by an employer to provide health and welfare benefits to its employees. Since the tax treatment of HWTs is not set out in the *Income Tax Act* (ITA), the CRA has published an administrative position which sets out the requirements of HWTs and the income tax consequences.

The Budget proposes to discontinue the application of CRA's administration position after the end of 2020 in order to encourage conversion of such trusts to employee health and life trusts for which there are specific rules in the ITA. The Department of Finance has requested comments on the transitional rules by June 29, 2018.

PERSONAL INCOME TAX MEASURES

The Budget did not propose a number of changes that were the subject of speculation prior to the Budget. The capital gains inclusion rate will not increase and remains at 50 per cent. In addition, proposals in respect of "surplus stripping" first introduced in July 2017, and then abandoned, have not been reintroduced.

Personal income tax rates will not increase under the Budget.

CANADA WORKERS BENEFIT (CWB)

The Budget enhances the existing Working Income Tax Benefit and renames it as the Canada Workers Benefit, effective for 2019 and subsequent years.

The CWB will be 26 per cent of "earned income" in excess of $3,000 to a maximum of $1,355 for single taxpayers without dependents and $2,335 for families (couples and single parents). The CWB is reduced where net income exceeds a threshold amount. The CWB disability supplement for individuals certified as eligible for the disability credit will be $700. Amounts will be indexed after 2019.

The Budget also proposes to allow the CRA to determine if a taxpayer is eligible for the CWB even if not claimed on their tax return and assess as if it had been claimed. This measure applies to tax returns for 2019 and subsequent taxation years.

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 include 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. Where the individual does not have a legal representative in place, certain family members (parents, spouses and common-law partners) are allowed to be the RDSP plan holder. 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.

CONTRIBUTIONS TO ENHANCED PORTION OF THE QUEBEC PENSION PLAN (QPP)

Individuals are currently entitled to a non-refundable credit in respect of employee contributions and the "employee" portion of self-employed contributions to the QPP. The QPP is being enhanced, starting in 2019. The Budget proposes that the enhanced part of the contributions be deductible to the individual.

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, from January 1, 2005 to June 30, 2016, 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.

MINERAL EXPLORATION TAX CREDIT FOR FLOW-THROUGH SHARE INVESTORS

Eligibility of the Mineral Exploration Tax Credit is proposed to be extended for one year under the Budget. The credit will apply to expenses renounced under flow-through share agreements entered into on or before March 31, 2019.

TRUSTS

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 certain 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, including 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 five per cent of the maximum fair market value of property held during the year with a minimum of $2,500.

INTERNATIONAL

SURPLUS STRIPPING

Section 212.1 is a provision that is intended to prevent a non-resident (the transferor) from stripping surplus out of a Canadian resident corporation (Canco) as a capital gain, which might be realized free of Canadian tax, rather than as a dividend that would be subject to Canadian withholding tax. In the absence of section 212.1, this could be achieved by the transferor by selling the shares of a Canco with accumulated surplus to another connected non-arm's-length Canco in return for a promissory note or shares with high paid-up capital (PUC).

A transferor that receives non-share consideration would be deemed by subsection 212.1 to have received a dividend to the extent that the non-share consideration exceeds the PUC of the transferred shares. If the transferor receives high PUC shares, the PUC of the shares received would be ground down to the PUC of the transferred shares.

The Budget proposes to introduce an anti-avoidance measure, effective for transactions on or after February 27, 2018, to prevent section 212.1 from being circumvented by having a partnership or trust own the surplus-laden Canco shares. The transferor would otherwise avoid section 212.1 under the current rules by selling the partnership or trust interest rather than the Canco shares.

FOREIGN ACCRUAL PROPERTY INCOME

In broad terms, foreign accrual property income (FAPI) is passive income earned by a "foreign affiliate" of a Canadian resident. FAPI is taxed on an 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 an 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 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.

Taxpayers whose foreign operations would not require more than five employees could pool their investments with other taxpayers in a similar position in an entity in which they would hold shares, the return on which would be tracked to their own investments. The pooled entity would require more than five full-time employees, thus converting the income of all the investors to active business income.

The Budget proposes to introduce measures that would prevent the circumvention of the "more than five employees" rule in this fashion. Each of the tracked pools would be treated as a separate business that would need to satisfy the "more than five employees" rule separately.

The Budget also proposes to introduce measures that are intended to prevent the avoidance of controlled foreign affiliate status using 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 that taxpayer's benefit. This proposal would deem a foreign affiliate of a taxpayer in this scenario to be a controlled foreign affiliate.

Regulated foreign financial institutions earning what would otherwise be FAPI are considered to be earning active business income if, among other conditions, they meet certain minimum capital requirements. These minimum requirements have not applied to trading or dealing in indebtedness. The Budget proposes to introduce measures that will apply similar minimum capital requirements to trading or dealing in indebtedness.

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

REASSESSMENTS

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 February 27, 2018.

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 February 27, 2018.

REPORTING REQUIREMENTS

The Budget proposes to shorten the filing deadline for the foreign affiliate information reporting (T1134) from the current 15 months after the taxpayer's year-end to six months after the year-end.

This proposal applies to taxation years that begin after 2019.

CHARITIES

MUNICIPALITIES AS ELIGIBLE DONEES

Where a registered charity's registration is revoked, either at its request or because of non-compliance, a revocation tax of 100 per cent of the net value of the charity's assets is imposed. This tax can be reduced by making qualifying expenditures, including gifts to "eligible donees," generally another registered charity where its directors/trustees are arm's length with those of the revoked charity.

The Budget proposes to allow transfers of property to municipalities to be qualified expenditures for this purpose, subject to case-by-case approval, thus reducing the revocation tax. This measure will apply to transfers made on or after February 27, 2018.

UNIVERSITIES OUTSIDE CANADA

Certain categories of "qualified donees," including universities outside Canada, are required to register with the CRA and are listed on the CRA website. Foreign universities are also required to be prescribed in the Income Tax Regulations. The Budget proposes to eliminate this duplication in respect of universities by removing the Income Tax Regulation requirement as of February 27, 2018.

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 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 the special HST rules as of January 1, 2018 (the September 8, 2017 proposals had extended the special HST rules that currently apply to investment plans, to investment limited partnerships effective January 1, 2019)

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.

TOBACCO TAXATION

The Budget proposes to increase the excise duty on tobacco products on an annual basis rather than to automatically increase it every five years to account for inflation. These inflationary increases will take effect on April 1 of every year, starting in 2019. Effective February 28, 2018, tobacco excise duty rates will be adjusted to account for the inflation since the last adjustment in 2014.

Cigarette inventories held by manufacturers, importers, wholesalers and retailers at the end of Budget Day will be subject to an inventory tax of $0.011468 per cigarette subject to certain exemptions. Taxpayers will have until April 30, 2018, to file returns and pay the cigarette inventory tax.

CANNABIS TAXATION

The Budget proposes a new excise duty framework for cannabis products to be introduced as part of the Excise Act. The duty will generally apply to all products available for legal purchase including fresh and dried cannabis, cannabis oils and seeds and seedlings for home cultivation. Cannabis cultivators and manufacturers (cannabis licensees) will be required to obtain a cannabis licence from the CRA and remit the applicable excise duty.

Excise duties will apply at the higher of a flat rate on the quantity of cannabis contained in the final product and a percentage of the dutiable amount as sold by the producer.

The GST/HST rules for basic groceries will be amended to ensure that any sales of cannabis products will not meet the zero-rating provisions and will be subject to GST/HST in the same way as sales of other cannabis products. In addition, the relieving rules for agriculture products will be changed to ensure sales of cannabis products including seeds or seedlings will also be subject to GST/HST.

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