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TAX FOCUS

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BUDGET 2018: A TARGETED APPROACH

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On February 27, 2018, the Federal Minister of Finance, Bill Morneau, tabled the current Liberal government's third budget. Following the proposals announced last year, there was much anticipation (and concern) that Budget 2018 would introduce additional sweeping tax changes. As expected, Budget 2018 proposed new tax rules applicable to passive investments held by private corporations. However, in the end, the changes in the latest budget proposals (the "Proposals") were much more targeted and measured than some had feared.

Here are some of the highlights.

Passive Investment Income in a Private Corporation

On July 18, 2017, the government released a consultation paper in which it proposed to restrict the tax-deferral advantage currently available to private corporations that reinvest after-tax profits in passive investments. In October 2017, the government announced that the proposals would be targeted at private corporations with annual passive investment income in excess of $50,000. While the specific mechanics of the proposals had not been announced, there was widespread concern that the proposed rules would be overly complex and onerous for small businesses.

Budget 2018 proposes a much more targeted and limited approach to reduce the deferral advantage for private corporations earning passive investment income. Specifically, two measures are proposed for taxation years beginning after 2018: (i) a reduction of the small business deduction; and (ii) restrictions on the access to refundable taxes by a private corporation in certain circumstances.

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Reduction of the Small Business Deduction

The small business deduction ("SBD") is a reduced tax rate on active business income earned by a Canadian-controlled private corporation ("CCPC"). Under current rules, the reduced rate is available on up to $500,000 in active business income. For 2018, the reduced combined federal-provincial tax rate in Ontario on income eligible for the SBD is 14.5%, reducing to 13.5% in 2019. The $500,000 business limit must be shared by associated corporations and is reduced for corporations (or associated groups) with more than $10 million of taxable capital.

Budget 2018 proposes to reduce the $500,000 small business limit for a CCPC to the extent that it and any associated corporations have passive investment income in excess of $50,000. The business limit will be reduced on a straight-line basis by $5 for every $1 of investment income, with the business limit being completely eliminated once the CCPC and associated corporations have $150,000 of investment income in a year.

For these purposes, Budget 2018 calculates passive income by reference to a new definition "adjusted aggregate investment income" ("AAII"). In general terms, AAII will exclude taxable capital gains (and losses) from the sale of assets used principally in an active business or from the sale of shares of a connected CCPC (as defined under Part IV of the *Income Tax Act* (Canada)) where all or substantially all of the assets are used principally in an active business in Canada. It will also exclude investment income that is incidental to the business. However, AAII will include dividends from non-connected corporations and income from savings in a life insurance policy that is not an exempt policy. Net capital losses carried over from other years will also be excluded from the calculation of AAII.

The Proposals contain certain anti-avoidance measures aimed at structures that attempt to avoid the new rules. For example, two related corporations could be deemed to be associated with each other if one corporation lends property to the other for the purposes of reducing the first corporation's AAII.

Refundability of Taxes on Investment Income

Budget 2018 also proposes to limit the tax advantage that can be obtained by CCPCs that recover refundable taxes on the payment of low-rate "eligible dividends". Currently, a corporation with a positive balance in its General Rate Income Pool ("GRIP") can obtain a refund of its refundable dividend tax on hand ("RDTOH") by paying a low-rate "eligible dividend" from its GRIP balance. Essentially, GRIP arises when a corporation earns business income that was not eligible for the lower small business tax rate. Where a corporation pays an eligible dividend out of GRIP to its individual shareholders, the individual is subject to personal tax at a lower tax rate than if it had not been designated as an eligible dividend. In Ontario, the difference between the eligible and non-eligible rates is approximately 8%.

For taxation years that begin after 2018, a corporation's RDTOH will be split into two accounts: eligible RDTOH and non-eligible RDTOH. The eligible RDTOH account will track refundable Part IV taxes paid on eligible dividends. The non-eligible RDTOH account will track the refundable portion of taxes on investment income (including capital gains) and Part IV tax on non-eligible dividends.

Under the Proposals, a refund of non-eligible RDTOH will only be available on the payment of non-eligible dividends. Any taxable dividend (eligible or non-eligible) will entitle the corporation to a refund from its eligible RDTOH account, except that the non-eligible RDTOH account must be exhausted for a non-eligible

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dividend to trigger a refund of eligible RDTOH.

For CCPCs, the lesser of its existing RDTOH balance and 38 1/3% of its GRIP balance will be allocated to its eligible RDTOH account. Any remaining balance will be allocated to its non-eligible RDTOH account. For any other corporations, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account

Practical Implications

On a practical note, even if a corporation's SBD is completely eliminated, a shareholder can still obtain a significant tax deferral by investing after-tax profits through a corporation. There are ways to manage the application of the Proposals by selecting the right investment portfolio. For example, private corporations should consider a portfolio of investments that generate little or no AAII. Non-income generating capital assets, such as real estate, held for future capital appreciation would be a good type of asset for a private corporation. If no income is generated, the corporation's business limit will not be reduced. In addition, if the capital property is disposed of only at the time when the individual shareholder of the corporation is retired and has no other substantial income, the payment of an ineligible dividend to the shareholder (thereby triggering an RDTOH refund to the corporation) may be inconsequential to the individual shareholder. Depending on the investment asset mix and the shareholder's necessity for cash flow, there is still an advantage for a private corporation to invest its after-tax corporate funds in passive investments.

Trust Reporting

Currently, the Canada Revenue Agency ("CRA") does not require a trust to file a tax return if it does not have income and/or if it does not make any distribution of its income or capital to its beneficiaries. The Federal Budget proposes to introduce new reporting requirements for certain trusts. Except for trusts that are exempt from these requirements (described below), trusts will be required to:

- disclose the identity of the beneficiaries, the settlor, the trustees and the protector (if any); and
- file an annual T3 return even if the trust has no income and/or no distributions are made to the beneficiaries.

There are penalties for failure to meet these reporting requirements. These new rules apply to returns required to be filed for the 2021 and subsequent taxation years.

These new reporting requirements do not apply to:

- mutual fund trusts, segregated funds and master trusts;
- registered plans
- lawyers' trust accounts;
- graduated rate estates and qualified disability trusts;
- non-profit organizations and registered charities; and
- new trusts that have been in existence for less than 3 months **or** that hold less than $50,000 in assets throughout the taxation year, provided that the assets are held in deposits, government debt obligations and listed securities.

Harmonized Sales Tax Measures

Investment Limited Partnerships

In September 2017, the Department of Finance released new rules to levy GST/HST in respect of management and administrative services provided to an investment limited partnership by the general partner of such partnership.

Budget 2018 confirms that the Department of Finance will proceed with these rules. It clarifies that the rules will apply to services rendered on or after September 8, 2017. GST/HST will be payable on the fair market

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value of the management and administrative services in the period in which these services are rendered.

Holding Corporations

Under the input tax credit regime, a GST/HST registrant is entitled to claim input tax credits in respect of taxable supplies acquired in the course of its commercial activity. Generally, a holding company will not satisfy this requirement, as the holding of shares (being a financial instrument) is not in itself a commercial activity. As a result, any taxable supplies acquired by a holding company would not be eligible for input tax credits. Section 186 of the *Excise Tax Act* (Canada) mitigates this discrepancy. The holding company is deemed to have acquired the taxable supplies in the course of commercial activities if it holds shares of a corporation that acquires all or substantially all of its supplies in the course of a commercial activity. Therefore, pursuant to subsection 186(1), the holding corporation may claim input tax credits in respect of taxable goods and services acquired in relation to its ownership of shares or debt in the subsidiary.

Budget 2018 indicates that the Department of Finance will review these rules in light of the required degree of relationship between the holding corporation and the subsidiary. It will also clarify the type of expenses that qualify for input tax credits. Draft legislation will be released at a future date.

Cannabis Taxation

Budget 2018 releases a new federal excise duty framework applicable to cannabis cultivators and manufacturers. This framework will come into effect when cannabis for non-medicinal purposes becomes available for legal retail sale.

Tax on Split Income

Budget 2018 confirms that the government will proceed with the proposed changes to the tax on split income, as originally announced on July 18, 2017 and further modified by tax measures released on December 13, 2017. Additional revisions to the proposed legislation were not announced.

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