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2018 FEDERAL BUDGET: EQUALITY AND GROWTH

On February 27, 2018, the Honourable Bill Morneau presented his third budget as Minister of Finance. The 2018 Federal Budget, entitled "Equality and Growth," focuses on:

1. Improving the economic success of women and advancing Canada's gender equality goals.
2. Enhancing innovation funding to improve the competitiveness of the Canadian business environment.
3. Continuing with its agenda of changing the tax rules for private companies by introducing new measures that impact the taxation of passive investments.

The key issues in the 2018 Budget for Canadian businesses include:

Gender equality—the government has made it a priority to address gender inequality in Canadian society and promoting the economic success of women. The government has indicated that the Budget measures have gone through a gender-based analysis with the goal of allocating government resources more equitably and efficiently. The Budget includes measures such as a new Women Entrepreneurship Strategy designed to increase the number of businesses owned by women and an enhanced parental leave Employment Insurance benefit for the second parent.

STATE OF THE DEFICIT

The federal government announced that the deficit for the 2017-18 fiscal year is $19.4 billion, which is lower than the $28.5 billion deficit predicted in last year's Budget. This is due to the enhanced performance of the Canadian economy over the past fiscal year. For the 2018-19 fiscal year a deficit of $18.1 billion is forecast, which includes a $3 billion contingency reserve. A significant concern for the Canadian business community is the balancing of the Budget and a plan for the elimination of the deficit, yet this Budget contains no mention of a plan for a return to surplus.

Innovation—there is significant concern in the Canadian business community that the renegotiation of NAFTA and the reduction of U.S. corporate tax rates as part of U.S. Tax Reform may have a negative impact on Canadian business competiveness. There was very little acknowledgement of these concerns in the Budget with the government only indicating that it will monitor the impact of the U.S. tax reforms on Canada. The Budget did contain new funding to support innovation in Canada with $2.6 billion to be spent over five years to transform Canada's innovation programs. No changes were announced to the Scientific Research and Experimental Development tax credit program.

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Private Company Taxation—the government introduced rules intended to limit the ability to build a passive investment portfolio owned by a private corporation. The rules announced are a significant improvement over the original proposals released in July 2017 and the revised proposals in October 2017. The small business deduction will be reduced by $5 for every $1 of investment income above the new annual $50,000 investment income limit and will be eliminated when annual investment income is $150,000 or higher.

The following is a summary of the important items of interest to our clients.

BUSINESS TAX MEASURES

Passive Investment Income in a Private Corporation

The government has introduced two separate measures to reduce the tax deferral benefit of earning investment income in a private corporation. These new rules will apply where the corporation also earns active business income taxed at the small business rate. These measures are substantially less aggressive than the proposals initially put forward in the July 2017 consultation paper, and more beneficial to taxpayers than the proposed relief announced in October 2017.

Measure #1—Limiting Access to the Small Business Tax Rate

Canadian-controlled private corporations (CCPCs) pay corporate income tax on active business income up to the small business limit at a low small business tax rate, currently 10 percent federally, to be reduced to 9 percent in 2019. The small business deduction limit is $500,000 federally and in most provinces (except for Manitoba where it is $450,000 and Saskatchewan where it is $600,000). Access to the small business tax rate begins to be phased-out for associated CCPCs with greater than $10 million of aggregate taxable capital employed in Canada and is eliminated when aggregate taxable capital reaches $15 million.

This Budget proposes to limit the ability of CCPCs to benefit from the small business tax rate where the corporation combined with its associated corporations earns more than $50,000 of passive investment income in a year. This $50,000 threshold was previously announced in October 2017 based on the government's estimate that it represents approximately $1,000,000 in invested assets, using an assumed 5 percent rate of return. This threshold is aimed at providing flexibility for small business owners to save for multiple purposes such as sick leave, parental leave, an economic downturn or retirement.

The Budget indicates that the small business deduction will be reduced by $5 for every $1 of investment income above the $50,000 threshold and will be eliminated when investment income reaches $150,000. This measure will affect CCPCs when the active business income exceeds the reduced small business limit. At $150,000 of investment income, the small business limit would be nil. Where active business income exceeds the reduced small business limit, the excess income will be taxed at the general corporate tax rate. This rate is 15 percent federally, and varies from 26.5 percent to 31 percent when combined with provincial or territorial tax rates.

The small business limit reduction under this measure will operate alongside the existing reduction that applies in respect of taxable capital in excess of $10 million. The reduction in the small business limit will be the greater of the reduction under the new measure and the existing reduction based on taxable capital.

Measurement of investment income

In order to apply this new measure, a new concept of "adjusted aggregate investment income" (AAII) is being introduced and will be based on "aggregate investment income" (a definition that is currently used in computing refundable taxes in respect of a CCPC's investment income) with certain adjustments.

Taxable capital gains and allowable capital losses arising from the disposition of "active assets" will not be included in AAII. "Active assets" is a defined term that includes property that is used principally in an active business carried on primarily in Canada by the corporation or by a related corporation. It also includes a share of another corporation that is connected with the corporation, where, generally, all or substantially all of the fair market value of the assets of the other CCPC is attributable directly or indirectly to assets that are used principally in an active business carried on primarily in Canada, and certain other conditions are met. Certain partnership interests will also be active assets.

In addition to excluding gains and losses from the disposition of active assets, AAII will include:

- dividends from non-connected corporations, and
- income from savings in a life insurance policy that is not an exempt policy, to the extent it is not otherwise included in aggregate investment income.

Net capital losses carried forward from other taxation years will be excluded from the calculation of AAII.

Consistent with the existing rules related to aggregate investment income, adjusted aggregate investment income will not include income that is incidental to an active business. In addition, investment income from AgriInvest is not considered to be passive income.

Application

This measure will apply to taxation years that begin after 2018. However, it may apply to an earlier tax year if the taxpayer enters into transactions designed to avoid the measure, such as the creation of a short taxation year in order to defer its application. In addition, a new anti-avoidance rule will generally apply to deem corporations to be associated where transactions are undertaken to transfer property to avoid the application of these rules.

Measure #2—Limiting Access to Refundable Taxes

The second measure dealing with tax advantages in respect of passive income is limiting access to refundable taxes for CCPCs. A refundable tax mechanism applies to the income of a private corporation from passive investments at approximately the top personal income tax rate while that income is retained in the corporation. Under this mechanism, the refundable taxes are added to the refundable dividend tax on hand (RDTOH) account and are refundable when the corporation pays taxable dividends to its shareholders. Taxable dividends paid from a corporation are classified as either eligible or non-eligible. Eligible dividends are those paid from income taxed at the general corporate rate and are taxed in the hands of the individual shareholder at a lower rate than non-eligible dividends.

A corporation can receive an RDTOH refund upon the payment of lower taxed eligible dividends in situations where the corporation's RDTOH was generated from investment income that would need to be paid as a non-eligible dividend. This can provide a tax deferral advantage as it still allows a CCPC to claim a refund of taxes paid on their investment income, which is intended to be taxed at higher rates.

This Budget proposes that a refund of RDTOH will generally only be available in cases where a private corporation pays non-eligible dividends. The current RDTOH account will now be referred to as "non-eligible RDTOH" and will track refundable taxes paid under Part I of the Income Tax Act (ITA) on investment income as well as under Part IV on non-eligible portfolio dividends (i.e. dividends that are paid by non-connected corporations as non-eligible dividends). Refunds from this account will be obtained only when non-eligible dividends are paid.

An exception will be allowed where RDTOH arises from eligible portfolio dividends received by the corporation. This new account will be "eligible RDTOH" and will track refundable taxes paid under Part IV of the ITA on eligible portfolio dividends. Any taxable dividend will entitle the corporation to a refund from its eligible RDTOH account (subject to an ordering rule).

With two accounts, an ordering rule will apply on the payment of a non-eligible dividend, such that a refund must be obtained from the non-eligible RDTOH account before obtaining a refund from the eligible RDTOH account. In situations with connected corporations, the account for the RDTOH addition for the recipient corporation will match the RDTOH account from which the payor corporation obtained its refund.

Application

This measure will apply to taxation years that begin after 2018. An anti-avoidance rule will apply to prevent the deferral of the application of this measure through the creation of a short taxation year.

On transition, a special rule will apply to determine how to allocate a CCPC's existing RDTOH balance between the two RDTOH accounts. Under this rule, the lesser of a CCPC's existing RDTOH balance and an amount equal to 38⅓ percent of the balance of its general rate income pool, if any, will be allocated to its eligible RDTOH account. Any remaining balance will be allocated to its non-eligible RDTOH account. For any other corporation, the existing RDTOH balance will be allocated to the corporation's eligible RDTOH account.

Health and Welfare Trusts

Requirements for a Health and Welfare Trust are set out in administrative positions published by the Canada Revenue Agency (CRA), while specific rules in the ITA apply for an Employee Life and Health Trust. The Budget proposes to discontinue the Health and Welfare Trust regime so that one set of rules applies to these arrangements. It is proposed that transitional rules will be added to the ITA to convert Health and Welfare Trusts to Employee Life and Health Trusts, and the CRA will no longer apply their administrative positions with respect to Health and Welfare Trusts after the end of 2020. Trusts that do not convert will be subject to the normal income tax rules for trusts. The CRA's administrative positions will not apply to a Health and Welfare Trust set up after February 27, 2018. The government will consult with stakeholders on transitional issues, after which time they will release draft legislative proposals and transitional administrative guidance. The government has invited stakeholders to submit comments on transitional issues by June 29, 2018.

At-Risk Rules for Tiered Partnerships

The government is proposing changes to the at-risk rules for partnerships in response to a recent Federal Court of Appeal decision dealing with tiered partnership structures. The "at-risk" rules have been administered based on the understanding that their application extends to cases in which the limited partner holding a limited partnership interest is another partnership (i.e. a tiered partnership structure). However, the case decision could result in limited partnership losses becoming deductible in situations using these structures where they would otherwise have been restricted. This Budget removes this inconsistency with a proposal to clarify that the at-risk rules apply to a partnership that is itself a limited partner of another partnership. In cases where a partnership that is a limited partner of another partnership, the losses from the other partnership that can be allocated to the partnership's members will be restricted by that partnership's at-risk amount in respect of the other partnership.

In addition, limited partnership losses of a limited partner that is itself a partnership will not be eligible for an indefinite carry-

forward. Such losses will be reflected in the adjusted cost base of the partnership's interest in the limited partnership.

This measure will apply in respect of taxation years that end on or after February 27, 2018, including in respect of losses incurred in taxation years that end prior to that day. In particular, losses from a partnership incurred in a taxation year that ended prior to February 27, 2018 will not be available to be carried forward to a taxation year that ends on or after that day if the losses were allocated—for the year in which the losses were incurred—to a limited partner that is another partnership.

Equity-Based Financial Arrangements

The government is proposing the following changes to deal with abusive arrangements aimed at circumventing the dividend rental arrangement rules.

Synthetic Equity Arrangements—Rules governing these arrangements will be amended to clarify the application of the no tax-indifferent investor exception. Under the proposal, this exception cannot be met when a tax-indifferent investor obtains all or substantially all of the risk of loss and opportunity for gain or profit in respect of the Canadian share, in any way, including where the tax-indifferent investor has not entered into a synthetic equity arrangement or a specified synthetic equity arrangement in respect of the share. The proposed amendment will apply to dividends that are paid, or become payable, on or after February 27, 2018.

Securities Lending Arrangements—The definition of "securities lending arrangement" will be broadened to capture substantially similar arrangements that are currently not caught to ensure that tax treatment is consistent. An amendment is also proposed to clarify the interaction of two rules governing the deductibility of dividend compensation payments made by a taxpayer under a securities lending arrangement. The proposed amendments to the securities lending arrangement rules will apply to dividend compensation payments that are made on or after February 27, 2018, unless the securities lending or repurchase arrangement was in place before this day, in which case the amendments will apply to dividend compensation payments that are made after September 2018.

Tax Support for Clean Energy

Capital cost allowance (CCA) class 43.2 provides an accelerated CCA rate 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 so that it is available in respect of property acquired before 2025.

PERSONAL TAX MEASURES

Enhanced Requirements for Trust Reporting

The Budget proposes an enhanced annual reporting structure for certain trusts that will require express trusts resident in Canada to file T3 returns, starting in 2021. Each trust will be required to report the identity of all trustees, beneficiaries and settlors of the trust, as well as the identity of each person who has the ability (through the trust terms or a related agreement) to exert control over trustee decisions regarding the appointment of income or capital of the trust (e.g., a protector). An express trust is generally a trust created with the settlor's express intent as opposed to a resulting or constructive trust, or certain trusts deemed to arise under the provisions of a statute.

The current rules provide that such trusts need only report in years that the trust has taxes payable or makes a distribution to one or more beneficiaries.

This enhanced reporting measure is proposed to improve the collection of beneficial ownership information with respect to trusts. This will help authorities more effectively counter aggressive tax avoidance, tax evasion, money laundering and other criminal activities perpetrated through the misuse of trusts.

Non-resident trusts that are currently required to file a T3 return will also be required to make an annual filing and to comply with the enhanced reporting requirements including the naming of beneficiaries. Certain trusts, such as graduated rate estates, trusts with a limited value of assets, mutual funds trusts and trusts governed by registered plans, will be exempt from this proposed new reporting regime. New penalties will be introduced for the failure to file a T3 return and will be equal to $25 per day of delinquency (with a minimum penalty of $100 and a maximum of $2,500), including an additional penalty where the failure to file the return was made knowingly or due to gross negligence. This additional gross negligence penalty will be equal to 5 percent of the maximum fair market value of property held during the year, with a minimum penalty of $2,500.

One of the effects of these proposals is that family trusts will need to be transparent with respect to all possible beneficiaries, even contingent beneficiaries, of the trust, as well as making annual trust filings in years where there is no distribution of income or capital.

Canada Workers Benefit

The Working Income Tax Benefit is a refundable tax credit that supplements the earnings of low-income workers. The Budget proposes to enhance this benefit starting in 2019 and to rename the benefit the Canada Workers Benefit.

It is proposed that the amount of the benefit for 2019 be equal to 26 percent of each dollar of earned income in excess of $3,000 to a maximum benefit of $1,355 for single individuals without dependants and to $2,335 for families (couples and single parents). The benefit will be reduced by 12 percent of adjusted net income in excess of $12,820 for single individuals without dependants and $17,025 for families. The enhancements will mean that the benefit will be extended to workers with adjusted net incomes up to approximately $24,000 for individuals and to approximately $36,400 for families.

Taxpayers who are eligible for the disability tax credit may receive a disability supplement to the new Canada Workers Benefit. In addition, the government proposes to increase access to the benefit to those who qualify for the benefit, but who have difficulty applying for it.

Other Changes

Medical Expense Tax Credit Eligible Expenditures—It is proposed that eligible expenses incurred after 2017 for the acquisition and care of a specially trained service animal will be allowed for a service animal trained to assist individuals to cope with certain severe mental impairments.

Charities and Transfers to Municipalities—This Budget proposes to amend the ITA to allow charities to consider transfers of property to municipalities qualifying expenditures for purposes of the revocation tax, subject to the approval of the Minister of National Revenue. This change will allow property of a charity to be transferred to a municipality, without detriment to the charity, for transfers made on or after February 27, 2018.

Mineral Exploration Tax Credit for Flow-Through Share Investors—The Budget proposes to extend eligibility for the credit for one year, to flow-through share agreements entered into on or before March 31, 2019.

INTERNATIONAL TAX MEASURES

Cross-Border Surplus Stripping using Partnerships and Trusts

The ITA contains a rule that is intended to prevent a non-resident shareholder from entering into transactions to extract a Canadian

corporation's surplus in excess of the paid-up capital (PUC) of its shares, or to artificially increase the PUC of such shares. PUC can be extracted from Canada and is not subject to taxation which is a valuable tax attribute in Canadian tax planning. When this rule is applied it can result in a deemed dividend to the non-resident or can suppress the PUC that would otherwise have been created as a result of the transactions. This Budget proposes to amend these rules to add comprehensive "look-through" provisions to ensure that the underlying purposes of the cross-border anti-surplus-stripping rule, and the corresponding corporate immigration rule, cannot be compromised by transactions involving partnerships or trusts. These rules will allocate the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries, as the case may be, based on the relative fair market value of their interests. This measure will apply to transactions that occur on or after February 27, 2018, while transactions that occur before this date may be challenged using the general anti-avoidance rule.

Foreign Affiliates - Reporting and Reassessments

This Budget proposes to bring the information return deadline in respect of a taxpayer's foreign affiliates (Form T1134) in line with the taxpayer's income tax return deadline by requiring the information returns to be filed within six months after the end of the taxpayer's taxation year. This measure will apply to taxation years of a taxpayer that begin after 2019. This is a significant change to the current rules that require the information return to be filed within 15 months of the year end of the taxpayer.

This Budget also proposes to apply the extended three year reassessment period in respect of income arising in connection with a foreign affiliate of the taxpayer. This measure will apply to taxation years of a taxpayer that begin on or after February 27, 2018.

Foreign Affiliates—Other Measures

This Budget also proposes several modifications to the rules for the taxation of Canadian resident shareholders of foreign affiliates, which in most cases will apply to taxation years of a foreign affiliate of a taxpayer that begin on or after February 27, 2018.

Investment Business—This Budget proposes to introduce 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 six employees test, in order for the affiliate's income from that business to be excluded from foreign accrual property income (FAPI).

Controlled Foreign Affiliate Status—This Budget also proposes to deem a foreign affiliate of a taxpayer to be a controlled foreign affiliate of the taxpayer if FAPI attributable to activities of the foreign affiliate accrues to the benefit of the taxpayer under a tracking arrangement. This measure is designed to ensure that each taxpayer involved in a tracking arrangement is subject to accrual taxation in respect of FAPI attributable to that taxpayer. FAPI is taxed immediately in Canada regardless if the taxpayer receives a distribution from the foreign affiliate.

Trading or Dealing in Indebtedness—This Budget proposes to add a minimum capital requirement to the trading or dealing in indebtedness rules of a foreign affiliate that is similar to a condition under the investment business rules which requires a taxpayer to satisfy certain minimum capital requirements in order to qualify for the regulated foreign financial institutions exception.

Reassessment Period

Requirements for Information and Compliance Orders—This Budget proposes to amend the ITA to introduce a "stop-the-clock" rule for requirements for information generally and for compliance orders. This rule will extend the reassessment period of a taxpayer by the period of time during which the requirement or compliance order is contested.

Non-Resident Non-Arm's Length Persons—This Budget proposes to amend the ITA to provide the CRA with an additional three years to reassess a prior taxation year of a taxpayer, to the extent the reassessment relates to the adjustment of a loss carryback, where specific criteria are met.

SALES AND EXCISE TAX, AND OTHER MEASURES

GST/HST and Investment Limited Partnerships

On September 8, 2017, the government released draft legislative and regulatory proposals relating to the application of the Goods and Services Tax/Harmonized Sales Tax (GST/HST) to investment

limited partnerships. This Budget confirms the government's intention to proceed with these proposals with specific modifications.

Consultations on the GST/HST Holding Corporation Rules

For GST/HST purposes, the "holding corporation rule" generally allows a parent corporation to claim input tax credits to recover GST/HST paid in respect of expenses that relate to another corporation. The government intends to consult on certain aspects of the holding corporation rule, particularly with respect to the limitation of the rule to corporations and the required degree of relationship between the parent corporation and the commercial operating corporation. The government intends to clarify which expenses of the parent corporation that are in respect of shares or indebtedness of a related commercial operating corporation qualify for input tax credits under the rule. Consultation documents and draft legislative proposals regarding these issues will be released for public comment in the near future.

Tobacco Taxation

This Budget proposes to advance the existing inflationary adjustments for tobacco excise duty rates to occur on an annual basis rather than every five years, and increase excise duty rates on cigarettes and other tobacco products.

Cannabis Taxation

This Budget proposes a new federal excise duty framework for cannabis products to be introduced as revisions to the Excise Act, 2001. The duty will generally apply to all products available for legal purchase, which at the outset of legalization will include fresh and dried cannabis, cannabis oils, and seeds and seedlings for home cultivation. The cannabis excise duty framework will come into effect when cannabis for non-medical purposes becomes accessible for legal retail sale.

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