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Canadian tax alert

2018-2019 federal budget highlights

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The Minister of Finance, Bill Morneau, presented the 2018-2019 federal budget in the House of Commons this afternoon. Key themes include growing the economy, gender equality and innovation. While the budget did not respond with any specific measures, the government acknowledged the significance of recent US tax reform and current negotiations of the North American Free Trade Agreement.

Following the proposals announced last year, the budget has introduced legislation to address the earning of passive income inside a private corporation. The two new proposed measures include reductions to the amount of income eligible for the small business tax rate for corporations earning passive income in excess of certain thresholds, and measures designed to limit the ability of corporate taxpayers to claim refunds resulting from the payment of dividends. Further details are discussed below.

From a gender equality perspective, the budget announces the introduction of a new “use it or lose it” Employment Insurance parental sharing benefit which will enable two-parent families that share parental leave to receive an additional five weeks of leave. The government also indicated an intention to provide additional support to women entrepreneurs and referenced its previously announced investments in affordable childcare.

The government is introducing significant new investments to better support Canadian innovators. In particular, more than $1.7 billion will be invested over five years to support current and future Canadian researchers through Canada's granting councils and research institutes, and over $1.3 billion will be committed over five years for investments in laboratories, equipment and infrastructure to support fundamental research.

The government continues to introduce measures to close loopholes that result in unfair tax advantages for some at the expense of others. Furthermore, the budget proposes to invest an additional $90.6 million over five years to build on previous investments to support the Canada Revenue Agency (CRA) in its efforts to prevent tax evasion and improve tax compliance.

Of note, the budget does not include further measures to address recommendations from the Organisation for Economic Co-operation and Development's base erosion and profit shifting project, particularly with respect to interest deductibility and anti-hybrid measures.

A summary of the economic and tax highlights contained in the budget is provided below.

Fiscal/economic outlook

The deficit for 2017-2018 is estimated to be $19.4 billion and a deficit of $18.1 billion is predicted for 2018-2019. The deficit is projected to decline gradually, reaching $12.3 billion by 2022-2023.

The federal debt-to-GDP ratio is estimated to be 30.1% for 2018-2019. This ratio is estimated to decline to 28.4% in 2022-2023.

GDP is expected to grow by 2.2% in 2018 and by 1.6% in 2019.

The CPI inflation rate for 2018 is estimated at 1.9% and is expected to remain stable over the next few years.

The unemployment rate for 2018 is estimated to be 6.0% and is expected to remain stable in the coming years.

Business income tax measures

Taxation of private corporations

Tax rates

- As previously announced, the federal government will reduce the small business tax rate from 10.5% to 10% for 2018 and to 9% for 2019 and beyond.

Passive investment income

- Effective for taxation years beginning after 2018, the budget introduces a mechanism by which the business limit of a Canadian-controlled private corporation (CCPC) will be reduced on a straight-line basis to the extent that it and associated corporations earn adjusted aggregate investment income (AAII) in excess of $50,000. Key aspects of this measure are as follows:
    - The business limit of a CCPC will be completely eliminated to the extent that its AAII, and that of all associated corporations, exceeds $150,000.
    - This reduction to the business limit will operate alongside the existing reduction imposed when taxable capital exceeds $10 million. The amount by which the business limit is reduced will be the greater of the two reductions.
- The Budget introduces the new concept of Adjusted Aggregate Investment Income which is based on aggregate investment income (AII); a concept that is currently used to calculate a CCPC's refundable tax liability. It is proposed that AAII will:
    - Include Canadian portfolio dividends and income from savings in a life insurance policy that is not an exempt policy (to the extent it is not otherwise included in AII);
    - Exclude taxable capital gains and losses from the disposition of assets used in an active business carried on primarily in Canada, and shares of a connected CCPC where all or substantially all of the fair market value of the assets of the other CCPC is attributable to assets used principally in an active business carried on primarily in Canada.
    - Exclude net capital losses carried over from other years.

Refundability of taxes on investment income

- The budget includes new measures, applicable to taxation years that begin after 2018, designed to restrict the situations in which a corporation can claim a refund of the balance in its refundable dividend tax on hand (RDTOH) account, as follows:
    - A corporation's RDTOH will be divided into two accounts: non-eligible RDTOH and eligible RDTOH. A corporation will no longer be able to obtain a dividend refund of non-eligible RDTOH by paying eligible dividends.
    - Where a corporation pays non-eligible dividends, it will be considered to recover non-eligible RDTOH first.
    - The eligible RDTOH account of a corporation will include:
        - Part IV refundable tax paid on eligible dividends received from non-connected Canadian corporations; and
        - Part IV refundable tax paid in respect of eligible dividends received from a connected Canadian corporation where the payment of such

dividends resulted in a dividend refund from the eligible RDTOH account of the other corporation.

  - Non-eligible RDTOH of a corporation will include:
    - The refundable portion of Part I tax;
    - Part IV refundable tax payable on non-eligible dividends from non-connected Canadian corporations; and
    - Part IV refundable tax paid to the extent dividends from a connected Canadian corporation resulted in a dividend refund from the non-eligible RDTOH account of the other corporation.
  - Anti-avoidance rules are also proposed in connection with both the proposed phase-out of the business limit, and the new rules pertaining to a corporation's RDTOH.

International tax measures

- Effective for taxation years beginning in 2020, the budget proposes to require taxpayers to file form T1134, *Information return relating to controlled and not-controlled foreign affiliates*, by the date on which the tax return for the year is due.
- Budget 2018-2019 proposes a series of additions to the foreign affiliate (FA) rules, effective for taxation years of an FA that begin on or after February 27, 2018, including:
  - A rule that deems the activities carried on by an FA to be a separate business, where the income from such activities accrues to the benefit of a specific taxpayer under a tracking arrangement. The rule is intended to prevent taxpayers from deferring taxation of passive income earned in an FA by pooling resources in a single entity that employs more than five individuals full time in the active conduct of its business.
  - Similar rules which cause an FA to be a controlled foreign affiliate of a Canadian taxpayer in situations where foreign accrual property income (FAPI) accrues to the benefit of a specific taxpayer under a tracking arrangement which makes use of separate cells or segregated accounts.
  - The introduction of a minimum capital requirement for FAs engaged in a business, the principal purpose of which is trading or dealing in indebtedness. If this requirement is not satisfied, the rule proposes to prevent such FAs from qualifying for certain exceptions from the FAPI rules.
- The budget proposes to extend, by three years, the reassessment period of taxation years of a taxpayer that begin on or after February 27, 2018, in respect of income arising in connection with an FA of the taxpayer.
- A "stop-the-clock" rule is proposed which would extend the reassessment period of a taxpayer by the amount of time taken to contest any requirement for information issued, or compliance order sought, by the CRA. Previously, such a rule only existed in respect of requirements for foreign-based information.

- In situations where a taxpayer incurs a loss in a tax year that begins on or after February 27, 2018, as a result of a transaction with a non-arm's length non-resident person, the budget proposes to extend by an additional three years the reassessment period in respect of the tax year to which the loss is carried back in order to permit consequential reassessments.
- The budget proposes a series of look-through rules which ensure that, as of February 27, 2018, Canada's existing anti-avoidance provisions pertaining to cross-border surplus stripping transactions cannot be circumvented through the use of partnerships and trusts.
- Various legislative amendments are proposed in order to facilitate the sharing of information in accordance with obligations under Canada's tax treaties, tax information exchange agreements and the Convention on Mutual Administrative Assistance in Tax Matters

Other business tax measures

- In response to the Federal Court of Appeal's decision in the case of *The Queen v. Green* (2017 FCA 107), the budget proposes to restrict the allocation of losses to members of a top-tier partnership in tiered partnership structures for taxation years that end on or after February 27, 2018, including losses incurred in tax years that ended prior to that date. Under these proposals, 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 indefinitely. Such unused losses will be added to the adjusted cost base of the partnership interests of the second-tier partnership.
- The budget extends eligibility for accelerated capital cost allowance to property acquired before 2025, where such property would otherwise qualify for inclusion in Class 43.2 of Schedule II of the Income Tax Regulations as investments in clean energy generation and conservation equipment.
- A variety of measures are proposed to broaden the dividend rental arrangement rules and securities lending arrangement rules in order to prevent taxpayers from claiming a deduction for intercorporate dividends received in situations where substantially all 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 the situations in which a dividend compensation payment can be deducted. With certain exceptions, these rules are effective for dividends paid, or dividend compensation payments made, on or after February 27, 2018.
- Where a corporation repurchases its shares on or after February 27, 2018, and such shares are held as mark-to-market property of a taxpayer, Budget 2018-2019 proposes certain amendments to ensure that any loss incurred by the taxpayer on the repurchase of said shares is reduced by the amount of the dividend deemed to have been received, provided a deduction in respect of intercorporate dividends is also available to be claimed.

- The budget announces the CRA's intention to discontinue the application of its longstanding administrative positions pertaining to health and welfare trusts after the end of 2020 in order to encourage conversion of such trusts to employee health and life trusts. Stakeholders are invited to submit comments on transitional issues before June 29, 2018.

Personal income tax measures

- New annual reporting requirements for trusts are proposed effective for 2021 and subsequent taxation years, along with additional penalties for failing to file a T3 return or failing to report requisite information. Highlights of the proposals include the following:
  - Affected trusts will be required to report the identity of all trustees, beneficiaries and settlors as well as any person who has the ability to exert control over certain trustee decisions.
  - Certain trusts will be required to file T3 returns, where no such requirement previously existed.
  - A number of types of trusts are exempted from the requirements, including, among others, mutual fund trusts, trusts governed by registered plans and graduated rate estates.
  - Funds are being allocated to the CRA to support this initiative.
- The budget proposes to extend, for another year, eligibility for the mineral exploration tax credit to flow-through share agreements. Thus, such agreements entered into on or before March 31, 2019 will qualify.
- It is proposed that the working income tax benefit will be renamed the Canada workers benefit and will be enhanced starting in 2019. The maximum benefit is proposed to be increased to $1,355 for a single individual without dependents, and $2,335 for a family. Individuals eligible for the disability tax credit will be entitled to additional benefits.
- Eligibility for the medical expense tax credit is proposed to be extended to costs incurred after 2017 in respect of an animal specially trained to perform tasks for an individual with a severe mental impairment, such as post-traumatic stress disorder.
- The temporary measure that allows a qualifying family member to become a plan holder of a registered disability savings plan for an adult individual who does not have a legal representative in place is proposed to be extended for five years, until the end of 2023.
- In order to provide consistent income tax treatment for contributions to the Canada Pension Plan and the Quebec Pension Plan (QPP), the budget provides for a deduction for employee contributions (and the employee portion of self-employed contributions) to the enhanced portion of the QPP, applicable for the 2019 and subsequent taxation years.

- The budget proposes to grant retroactive eligibility for the former Canada child tax benefit, national child benefit supplement and the universal child care benefit to foreign-born status Indians who are neither Canadian citizens nor permanent residents of Canada. This amendment applies from the 2005 taxation year until June 30, 2016.
- In order to ensure provincial/territorial access to taxpayer information necessary for the administration of social assistance programs, the Income Tax Act will be amended to provide legislative authority for sharing information related to the Canada child benefit as of July 1, 2018.
- In certain circumstances, with approval of the Minister of National Revenue, it is proposed that a charity whose registration has been revoked will be able to treat a municipality as an eligible donee, in order to allow the charity to avoid a revocation tax equal to 100% of the net value of its assets. This measure will apply to transfers of assets on or after February 27, 2018.
- To streamline the registration process by which universities outside of Canada become qualified donees for purposes of the charitable donation tax credit, as of February 27, 2018, such universities will no longer be required to be prescribed in the Income Tax Regulations.

Other measures

- The budget proposes to introduce a new federal excise duty framework for cannabis products as part of the Excise Act, 2001. Excise duties will be imposed on federally-licenced producers on all products available for legal purchase at the higher of a flat rate applied on the quantity of cannabis contained in a final product and a percentage of the dutiable amount of the product as sold by the producer. The framework will come into effect when cannabis becomes available for legal retail sale and will provide certain transitional rules.
- The budget confirms that the government will proceed with the draft legislative and regulatory proposals released on September 8, 2017 relating to the application of GST/HST to investment limited partnerships, subject to certain changes which cause certain measures to only be applicable prospectively as of September 8, 2017.
- The existing inflationary adjustments for tobacco excise duty rates are proposed to apply annually rather than every five years.
- The excise duty rates on cigarettes are proposed to increase by an additional $1 per carton of 200 cigarettes. Furthermore, inventories of cigarettes held by manufacturers, importers, wholesalers and retailers held at the end of February 27, 2018 will be subject to an inventory tax of $0.011468 per cigarette, subject to certain exemptions.
- The government intends to release consultation documents and draft legislative proposals for public comment on certain aspects of the GST/HST holding corporation rules in the near future.

For further details, we refer you to the Ministry of Finance website.

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