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Tax, Retirement & Estate Planning Services

2018 FEDERAL BUDGET

Budget 2018 – Phew, That could have been a lot worse…..

Introduction

Finance Minister, Bill Morneau, delivered the majority Liberal government's third Federal Budget on February 27, 2018. Budget 2018 announces no tax rate changes either personally or corporately and confirms the corporate tax rate reductions previously announced. The big news is that the passive investment proposals were better than expected. The original proposals have been significantly diluted – the Government listened to the 21,000 submissions by simplifying and narrowing their approach.

The following represents a summary of measures of interest to investment and insurance advisors.

Business Tax Measures

Holding Passive Investments Inside a Private Corporation

The private corporation tax proposals released in July 2017 included measures to deal with the increasing number of business owners holding passive investments inside their corporations, where they benefit from a tax deferral advantage compared to distributing the assets from the corporation and investing personally. Rather than removing access to the refundable taxes as proposed in July 2017, the Government is now proposing two new measures to limit deferral advantages from holding passive investments in a corporation.

Small Business Limit

The first measure proposes to limit the ability of businesses with significant passive investment income to benefit from the small business tax rate. The current small business limit allows for up to $500,000 of active business income to be subject to the lower small business tax rate (which the Government has proposed to reduce from 10.5% to 10% for 2018 and to 9% for 2019), versus the general business tax rate which is currently 15% federally.

Under the proposal, if a corporation (and its associated corporations) earn more than $50,000 of passive investment income in a given year, the amount of income eligible for the small business tax rate would be gradually reduced. It is proposed that the small business limit be reduced by $5 for every $1 of passive investment income above the $50,000 threshold, such that the small business limit would be reduced to zero at $150,000 of passive investment income.

For example, if a CCPC has $100,000 of passive investment income its small business limit will be reduced to $250,000 ($500,000 – (excess $50,000 X $5)). If the corporation has $200,000 of active business income, it will not be impacted by the reduced small business limit. The full $200,000 will be taxed at the small business tax rate. However, if the corporation has $325,000 of active business income, it will only benefit from the small business tax rate on the first $250,000 of its active business income. The other $75,000 ($325,000 - $250,000) will be taxed at the higher general corporate tax rate.

For a purely investment holding company that is not associated with an active business, there is no change to the taxation of passive investments and the distribution of this income. This is a significant and welcome departure from the original proposals. And, even where there is an impact, it only affects the tax rate applied to the active business income. No tracking, no pools, no grandfathering of existing assets, but that's a good thing!

Investment income will be measured by a new concept of "adjusted aggregate investment income" which will not include capital gains from the sale of property used in an active business or the sale of shares of an active business that is connected with the corporation, and investment income that is incidental to the active business. Adjusted aggregate investment income will include dividends from non-connected corporations and income from savings in a **non-exempt** life insurance policy. Gains arising from the disposition of an exempt policy and income from annuities held by private corporations are included but again, nothing about the taxation of these amounts is changing, just this income may impact a corporation's small business limit.

As far as investment choices within corporations, the same rules of thumb apply now as they did before – tax efficiency and tax deferral should still be top of mind. Along those lines, corporate class mutual funds can be attractive because they don't distribute interest and foreign income (the least tax-efficient types of income) and only distribute ordinary Canadian dividends or capital gains which are more tax-efficient. Furthermore, the ability for mutual fund corporations to pool expenses and losses provides the potential to reduce taxable distributions. Even where income is generated from such investments, nothing about the taxation of them is changing, just access to the small business limit may be impacted.

Refundability of Taxes on Investment Income

The second passive investment income measure will limit tax advantages that large Canadian controlled private corporations (CCPCs) can obtain by accessing refundable taxes on the distributions of certain dividends. The current tax regime is designed to tax passive investment income earned by a CCPC at a higher rate, roughly equivalent to the personal top tax rate, and to refund a portion of the corporate tax when the passive investment income is paid out to its shareholders.

Generally, passive investment income earned by a CCPC must be paid out as a non-eligible dividend. However, in practice, any dividend paid by a CCPC can generate a refund of the refundable tax, regardless of the source of the dividend (i.e. whether coming from passive investment income or lower taxed active business income). This means that large CCPCs could pay out lower taxed eligible dividends from their pool of active business income taxed at the general corporate tax rate, and still claim a refund of taxes paid on their passive investment income, providing a tax advantage.

To better align the refund of taxes paid on passive investment income with the payment of dividends sourced from passive investment income, Budget 2018 proposes that a refund of refundable tax be available only in cases where a CCPC pays non-eligible dividends. An exception will be provided in respect of refundable tax that arises from eligible portfolio dividends received by a CCPC, in which case it will still be able to obtain a refund of that refundable tax upon the payment of eligible dividends.

The small business limit and refundable tax measures will both apply to taxation years that begin after 2018. And both measures include anti-avoidance rules to prevent transactions that will avoid the measures, such as the creation of a short taxation year or in the case of the small business limit, transfer of the assets to a related corporation that is not associated with it.

Health and Welfare Trusts

A Health and Welfare Trust (HWT) is a trust established by an employer for the purpose of providing health benefits to its employees. The tax treatment of a HWT is not explicitly set out in the Income Tax Act, however the CRA has published its administrative positions regarding HWTs. Similarly, an Employee Life and Health Trust (ELHT) also provides health benefits to employees, specifically group sickness or accident insurance plans, private health services plans (PHSP) and group term life insurance policies. The ELHT rules were added to the Income Tax Act in 2010.

The ELHT rules in the Income Tax Act are very similar to the CRA's administrative positions for HWTs. Budget 2018 proposes that only one set of rules apply to these arrangements. The CRA will no longer apply their administrative positions to HWTs after the end of 2020. To facilitate the conversion of existing HWTs to ELHTs, transitional rules will be added to the Income Tax Act. In addition, the CRA will not apply its administrative positions to HWTs to trusts established after Budget Day and will announce transitional administrative guidance relating to winding up existing HWTs.

The Government is seeking comments until June 29, 2018. Draft legislation will follow.

Personal Tax Measures

Budget 2018 proposes the following tax measures for individuals:

Registered Disability Savings Plan (RDSP) – Qualifying Plan Holders

Where the capacity of an adult individual entering into a RDSP contract is in doubt, the plan holder of the individual's RDSP must be the individual's legal representative, as recognized under provincial or territorial law. Where the adult individual does not have a legal representative in place, a temporary federal measure exists to allow a qualifying family member (i.e., a parent, spouse or common-law partner) to be the plan holder of the individual's RDSP. This measure is legislated to expire at the end of 2018.

Budget 2018 proposes to extend the temporary measure by five years, to the end of 2023.

Medical Expense Tax Credit

Budget 2018 proposes to expand the medical expense credit to recognize such expenses where they are incurred in respect of an animal specially trained to perform tasks for a patient with a severe mental impairment.

This measure will apply in respect of eligible expenses incurred after 2017.

Deductibility of Employee Contributions to the Enhanced Portion of the Quebec Pension Plan

To provide consistent income tax treatment of CPP and QPP contributions, Budget 2018 proposes to provide a deduction for employee contributions (as well as the "employee" share of contributions made by self-employed persons) to the enhanced portion of the QPP. The Government of Quebec announced on November 21, 2017 that the enhanced portion of employee CPP and QPP contributions will be deductible for Quebec income tax purposes.
These measures will begin in 2019 and be fully phased in by 2025.

Mineral Exploration Tax Credit for Flow-Through Share Investors

The Government proposes to extend eligibility for the mineral exploration tax credit for an additional year, to flow-through share agreements entered into on or before March 31, 2019.
This measure will apply as of Budget Day.

Reporting Requirements for Trusts

Budget 2018 proposes to require that trusts provide additional information annually and will impose an obligation to file a T3 return where one does not currently exist. The new requirements will apply to returns filed for the 2021 and subsequent taxation years.

The new reporting requirements will not apply to the following trusts:

- mutual fund trusts, segregated funds and master trusts;
- trusts governed by registered plans (i.e., DPSP, RPP, RDSP, RRSP, RRIF, TFSA);
- lawyers’ general trust accounts;
- graduated rate estates and qualified disability trusts;
- trusts that qualify as non-profit organizations or registered charities; and
- trusts that have been in existence for less than three months or that hold less than $50,000 in assets throughout the taxation year (provided, in the latter case, that their holdings are confined to deposits, government debt obligations and listed securities).

Where the new reporting requirements apply to a trust, the 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.

The proposed measures are meant to improve collection of beneficial ownership information which appears to be a concern for the Government as is consistent with what’s happening globally. As well, Finance is proposing to strengthen the availability of beneficial ownership information by amending the Canada Business Corporations Act.

Conclusion

What a relief! It’s still complicated and analysis of the details will be required.   But, we finally have some certainty. It’s OK to talk about corporate-owned life insurance and investments! The measures that are proposed are targeted at what the Government was concerned with most – being taxed at the small business tax rate and investing in passive investments. The consequences are now targeted at limiting access to the low small business tax rate and not the taxation of passive investments themselves.

The commentary in this publication is for general information only and should not be considered legal, tax or other professional advice to any party. Individuals should seek the advice of professionals to ensure that any action taken with respect to this information is appropriate to their specific situation.

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