TAX FLASH BULLETIN

2018 Federal Budget Highlights

On February 27, 2018, Federal Finance Minister Bill Morneau tabled the Liberal Party's federal budget. The minister forecasts the current fiscal year will end with a $19.4 billion deficit versus the $28.5 billion deficit estimated in last year's budget. The current budget projects an $18.1 billion deficit for the 2018-2019 fiscal year with no timetable to return to a balanced budget by 2022-2023. We have highlighted selected income tax changes that affect Canadian individuals and businesses including the taxation of passive investment income earned inside a corporation.

INDIVIDUALS

Personal Tax Rates

The budget does not propose any changes to individual income tax rates. The taxable income figures below reflect the indexed income brackets for 2017 and 2018.

2017 Taxable Income	2017 Tax Rates	2018 Taxable Income	2018 Tax Rates
$0 to $45,916	15%	$0 to $46,605	15%
$45,916 to $91,831	20.5%	$46,605 to $93,208	20.5%
$91,831 to $142,353	26%	$93,208 to $144,489	26%
$142,353 to $202,800	29%	$144,489 to $205,842	29%
Over $202,800	33%	Over $205,842	33%

Registered Disability Savings Plans (RDSP) – Qualifying Plan Holders

The Income Tax Act requires that the plan holder of an individual's RDSP be the individual's legal representative as appointed under provincial or territorial law where an adult individual lacks contractual capacity. In the case where adult individual does not have a legal representative, there is a temporary measure that allows a qualifying family member (i.e. a parent, spouse, or common-law partner) to be the plan holder of an individual's RDSP. The budget proposes to extend the temporary measure which was set to expire at the end of 2018 to the end of 2023. The federal government is emphasizing the importance of obtaining a legal representative and is encouraging the provinces and territories to streamline their appointment processes.

Extension of Mineral Exploration Tax Credit

The budget proposes to extend the mineral exploration tax credit for one year to flow-through share agreements entered into on or before March 31, 2019. The federal credit is equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

Expansion of Medical Expense Tax Credit

Budget 2018 expands the medical expense tax credit to service animals that are specially trained to perform tasks for a patient with a severe mental impairment in order to assist them in coping with their impairment. Expenses will not be eligible if the support animal has not been specially trained to perform specific tasks. Under current law, animal care expenses are eligible for the credit if the animal is specially trained to assist patients coping with blindness, profound deafness, severe autism, severe diabetes, severe epilepsy, or a severe and prolonged impairment that markedly restricts the use of the patient's arms or legs.

Deductibility of Enhanced Quebec Pension Plan (QPP)

On November 2, 2017, the government of Quebec announced the Quebec Pension Plan (QPP) would be enhanced in a manner similar to the enhancement of the Canada Pension Plan (CPP) that was announced in 2016. To provide consistent income tax treatment of CPP and QPP contributions, the federal budget proposes to provide a deduction for employee contributions to the enhanced portion of the QPP. Quebec also announced that the enhanced portion of CPP and QPP will be deductible for Quebec income tax purposes. This measure is effective starting in 2019 and subsequent years.

Enhanced Canada Workers Benefit

Budget 2018 proposes to rename the refundable Working Income Tax Benefit (WITB) for low-income workers with the new Canada Workers Benefit. This enhanced benefit will be equal to 26% of each dollar of earned income in excess of $3,000 up to a maximum benefit of $1,355 for single individuals without dependants and up to $2,335 for families (couples and single parents). The benefit will be clawed back by 12% of adjusted net income in excess of $12,820 for single individuals and $17,025 for families. This measure applies to the 2019 and subsequent taxation years (indexed).

Donations to Universities Outside Canada

Budget 2018 proposes to remove the requirement that universities outside Canada be prescribed in the Income Tax Regulations on Schedule VIII to be a qualified donee for the charitable donation tax credit. The university will be considered a qualified donee if it is registered with the Canada Revenue Agency on the Government of Canada's website. The university no longer has to be registered on both lists. This measure is effective February 27, 2018.

New Trust Reporting Requirements

As part of the government's strategy to prevent aggressive tax avoidance, tax evasion, money laundering, and other criminal activities, the budget proposes to improve the collection of beneficial ownership information for trusts. The trust will be required to report the identity of all trustees, beneficiaries, settlors, and the persons who have the ability to exert control over trustee decisions. In addition, certain trusts that do not currently have an obligation to file a T3 trust tax return will now have an obligation to file.

The new reporting requirements will apply to express trusts that are resident in Canada and to non-resident trusts that are currently required to file a T3 return. An express trust is generally a trust created with the settlor's express intent, usually made in writing (as opposed to a resulting or constructive trust, or certain trusts deemed to arise under the provisions of a statute). Exceptions to the additional reporting requirements are proposed for the following trust types:

- mutual fund trusts, segregated funds and master trusts;
- trusts governed by registered plans (i.e., deferred profit sharing plans, pooled registered pension plans, registered disability savings plans, registered education savings plans, registered pension plans, registered retirement income funds, registered retirement savings plans, registered supplementary unemployment benefit plans and tax-free savings accounts);
- 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).

The budget also introduces new penalties for failure to file a T3 return, including the beneficial ownership schedule, equal to $25 for each day of delinquency, with a minimum penalty of $100 and a maximum of $2,500. Gross negligence penalties may also apply at the rate of 5% of the maximum fair market value of the property held during the trust year, with a minimum penalty of $2,500.

The new reporting requirements and penalties will apply to trust returns required to be filed for the 2021 and subsequent taxation years.

BUSINESSES

The budget does not propose any changes to the federal corporate income tax rates, but it proposed changes to the calculation of the $500,000 small business limit in relation to the passive investment income proposals. See below for further details. The budget confirms the small business tax rate is on schedule to be reduced to 9% effective January 1, 2019.

Federal Corporate Tax Rates

Income Type	2017	2018	2019
General corporate income	15.00%	15.00%	15.00%
Small business income	10.50%	10.00%	9.00%
CCPC investment income	38.67%	38.67%	38.67%
Non-CCPC investment income	15.00%	15.00%	15.00%
Manufacturing & processing income	15.00%	15.00%	15.00%

As a reminder, the non-eligible dividend tax credit rates will change as a result of the reduction in the small business tax rate.

Non-Eligible Dividends	2017	2018	2019+
Dividend gross-up rate	17%	16%	15%
Dividend tax credit factor based on gross-up amount	21/29	8/11	9/13
Dividend tax credit rate as a % of actual dividend	12.31%	11.64%	10.38%

New Measures for the Taxation of Passive Income

In October 2017, the government announced that passive investment income up to $50,000 earned by a private corporation would not be subject to any tax increases under pending legislation. At that time, the government did not provide any details about how the government planned to tax passive income above $50,000. In budget 2018, the government proposes two new measures to tackle excessive passive income by limiting a Canadian-Controlled Private Corporation's (CCPC) access to the small business tax rate and by dividing the refundable dividend tax on hand (RDOTH) account into eligible and non-eligible pools. These measures are effective for taxation years that begin after 2018.

Limiting Access to the Small Business Tax Rate

The budget proposes to reduce the amount of the $500,000 small business limit amount by $5 for every $1 of passive investment income that exceeds $50,000 for a CCPC and its associated corporations. Therefore, the small business limit would be reduced to zero at $150,000 of investment income and a CCPC would pay the 15% general tax rate on active business income instead of the 10% small business tax rate for 2018. As long as the reduced business limit remains above the active business income of the CCPC (and its associated corporations), all of the active income will continue to be taxed at the small business rate.

Example (assume the corporation has less than $10 million of taxable capital):

Active business income is $75,000

Passive investment income is $130,000

Small business limit is $500,000 – ($5 x [$130,000 - $50,000 threshold]) = $100,000

The adjusted business limit of $100,000 allows the full $75,000 of active income to be taxed at the 10% small business rate.

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

Passive Investment Income Defined

For the purposes of defining the passive income reduction to the small business limit, the new rules introduce the concept of "adjusted aggregate investment income" which is based on the current concept of "aggregate investment income" with certain adjustments. The adjustments will include the following:

- taxable capital gains (and losses) will be excluded to the extent they arise from the disposition of
  - a property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC; or
  - a share of another CCPC that is connected with the CCPC, where, in general terms, 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;
- net capital losses carried over from other taxation years will be excluded;
- dividends from non-connected corporations will be added;
- 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.

The existing rules with respect to incidental passive income to an active business will exclude such income from reducing the small business limit.

Changes to Refundable Taxes on Investment Income

Under the current tax regime, an additional refundable tax is charged on passive income earned by a corporation. These "additional taxes" are added to the refundable dividend tax on hand (RDTOH) account, which are refundable at a rate of $38.33 for every $100 of taxable dividends paid to shareholders. Taxable dividends for the purposes of obtaining a dividend refund include non-eligible and eligible dividend types.

Budget 2018 proposes that a refund of RDTOH is only available in cases where the corporation pays non-eligible dividends. An exception will be provided where the portion of the RDTOH balance arises from the receipt of eligible portfolio dividends as opposed to income in the general rate income pool (GRIP). An eligible dividend payment to a shareholder sourced from an eligible dividend income receipt by the corporation will still be able to obtain a refund of that RDTOH.

The different treatment of the refundable taxes will necessitate the dividing of the RDTOH accounts between "eligible RDTOH" which represents refundable Part IV taxes on eligible portfolio dividends and "non-eligible RDTOH" which represents refundable Part I taxes. Where a private corporation pays non-eligible dividends, it is required to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

The budget outlines transitional rules for allocating a corporation's existing RDTOH balance:

- For a CCPC, the lesser of its existing RDTOH balance and an amount equal to 38⅓ per cent 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, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

This measure will apply to taxation years that begin after 2018.

Conversion of Health and Welfare Trusts

A Health and Welfare Trust is a trust established by an employer for the purpose of providing health and welfare benefits to its employees. The tax treatment of such a trust is not explicitly set out in the Income Tax Act. The Employee Life and Health Trust rules added to the Income Tax Act in 2010 are very similar to Canada Revenue Agency's (CRA) administrative positions for Health and Welfare Trust.

The budget proposes to apply only one set of rules to both of these arrangements to reduce confusion and to provide consistency in the tax treatment of such arrangements. CRA will no longer apply their administrative tax treatment of Health and Welfare Trust after the end of 2020. The trusts must be converted to Employee Life and Health Trusts otherwise the trust will be subject to the normal income tax rules for trusts. Further, CRA will not recognize Health and Welfare Trusts established after February 27, 2018.

Stakeholders are invited to submit comments on transitional issues by June 29, 2018 to HWT-consultation-FSBE@canada.ca.

Income Sprinkling Measures

The budget did not contain a deferral or any changes to the income sprinkling legislation released on December 13, 2017. Those measures remain generally effective for the 2018 and later years.

The government also made no further mention in budget 2018 about changing the tax rules related intergenerational family transfers of businesses or changing the lifetime capital gains exemption.

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