Grant Thornton
An instinct for growth™

Budget 2018
What does it mean to you?

March 2018

Tax alert

On February 27, 2018, Finance Minister Bill Morneau presented the government's 2018-2019 federal budget. A full summary of the proposed tax measures announced in the budget can be found here. We have highlighted in this alert some key tax proposals that you should be aware of and how they may impact you and your business.

US tax reform

The only reference in Budget 2018 in response to the US tax reform was the following note: “over the coming months, the Department of Finance will conduct detailed analysis of the US federal tax reforms to assess any potential impacts on Canada”. Although this should not be a surprise given that Bill Morneau pretty much indicated this to the media just before the budget was released, many had nevertheless hoped for some income tax rate cuts. For decades, Canada has been the “low rate” jurisdiction. Now, however, with the tax rate reductions in the US, many businesses fear that investment dollars could be redirected from Canada to the US. Interestingly, this may be more of a provincial tax rate issue[1] as the Canadian federal corporate tax rate is still lower than the US federal corporate tax rate.

From a personal perspective, the newly-reduced top individual tax rate, combined with the strong US dollar, could also induce highly-skilled Canadian workers and professionals who are mobile to move their talents across the border.

Hopefully, the government will conduct its analysis on a timely basis and respond swiftly to any potential impact the US proposals may have on Canada.

Passive income

The proposed measures included in Budget 2018 to address the perceived tax advantages from holding passive investments inside a private corporation is a welcome change compared to the approaches that were contemplated in the July 18, 2017 Consultation Paper on “Tax Planning Using Private Corporations”, which were extremely complex and required tracking of various pools. The government, instead, dealt with the perceived tax advantage by limiting access to the small business deduction (SBD) and made some changes to the refundable tax mechanism that applied when Canadian-controlled private corporations (CCPCs) earn passive income.

[1] The general US federal corporate income tax rate is 21%, while Canada’s is 15%. The tax rate for most states is around 6-8%, whereas for most provinces it is around 11-12%.

Restrictions to the small business deduction (SBD)

Under the proposed measures, if a CCPC and its associated corporations earn more than $50,000 of income from passive investments for the year, the amount of income eligible for the SBD would be gradually reduced[2]—no income will be eligible for the SBD where the CCPC and its associated corporations earn $150,000 or more of income from passive investments.

As such, if you expect your corporation’s income from passive investments, plus those of any associated corporations, to exceed $50,000 in a given year, you may want to consider the following to maximize the amount of income eligible for the SBD:

Alternative investments vehicles

Consider alternative investment vehicles, which provide savings yet do not produce an annual income entitlement that would be taken into account in the measurement of the $50,000 income threshold. Alternative investment vehicles can include tax-exempt life insurance policies, retirement compensation arrangements (RCAs) and individual pension plans (IPPs).

As with any investments, it is important to ensure that the costs and benefits of the particular arrangement align with your specific needs.

Deducting expenses

Relevant expenses can reduce income for purposes of the $50,000 income threshold. Consequently, it makes sense to ensure that such expenses are being appropriately tracked and allocated.

Use of capital losses in the year they are incurred

The proposed measures exclude net capital losses carried over from other taxation years as a deduction in determining the $50,000 threshold limit.

[2] It is proposed that the SBD limit (maximum of $500,000) be reduced by $5 for every $1 of investment income above the $50,000 threshold.

Therefore, if a company realizes a capital loss in a given year, consideration should be given to triggering any accrued capital gains in the same year in order to claim the benefit of the loss rather than carrying it forward to a future year, where it will not be able to reduce those future-year gains for purposes of calculating the $50,000 income threshold.

Impact to associated corporations involving a trust

If you have a structure where a family trust holds shares of a holding company—Holdco, where Holdco only earns income from passive investments—and a beneficiary of the family trust also owns shares of an active business— Opco, where Opco's income would otherwise be eligible for the SBD—under the current tax rules, Holdco and Opco would be considered associated.

Under the proposed measures, Holdco's income can now impact Opco's ability to claim the SBD. To the extent Holdco's income exceeds $50,000, the amount of Opco's income eligible for the small business deduction will be gradually reduced.

It is consequently important to determine which companies in the group are associated and consider the mix of assets being held inside a corporation (i.e., passive investments generating income).

Implications to the refundable dividend tax on hand (RDTOH) account

To better align the refund of taxes paid on passive income with the payment of dividends sourced from passive income, Budget 2018 proposes that a refund of the RDTOH will now only be available where a private corporation pays non-eligible dividends (i.e., dividends paid from passive income or from active income that has benefited from the small business tax rate or any other special tax rate and therefore, is not entitled to the enhanced dividend tax credit). An exception will be provided for eligible dividends paid to obtain a refund of taxes paid on eligible portfolio dividends received by a CCPC.

This would be facilitated by having two separate RDTOH accounts: an eligible RDTOH account (which will track refundable taxes paid under Part IV of the *Income Tax Act* on eligible portfolio dividends) and a non-eligible RDTOH account (which will track refundable taxes paid on investment income and refundable taxes paid under Part IV of the *Income Tax Act* on non-eligible portfolio dividends). Refunds from the non-eligible RDTOH account will be obtained only upon the payment of non-eligible dividends.

An ordering rule has also been included in the proposals, which requires a CCPC, upon the payment of a non-eligible dividend, to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

Although tracking two separate RDTOH accounts will now be required, this is not expected to be onerous. It will also be important to determine the opening RDTOH balances to ensure the dividends are aligned with the appropriate RDTOH account going forward.

Anti-avoidance rule

An anti-avoidance measure was also introduced to prevent the deferral of the application of these measures by creating a short taxation year. That means the timeframe to carry out any planning prior to the application of the rules is limited.

Other business measures

Health and welfare trusts

Typically, employers currently use either a health and welfare trust (HWT) or an employee life and health trust (ELHT) to fund their employee benefits. Although the tax treatment of these two trust arrangements is very similar, HWTs are governed under published administrative positions issued by the Canada Revenue Agency, whereas ELHTs are governed by legislation contained in the *Income Tax Act*. Furthermore, the ELHT rules deal with certain issues that are not dealt with in the administration of the HWT regime, such as the treatment of surplus income.

Budget 2018 proposes that existing HWTs will need to transition to the existing ELHT regime so that only one set of rules apply to these types of trust arrangements after the end of 2020.

The government intends to announce transitional administrative guidance relating to the winding up of existing HWTs. The government is seeking feedback from the public until June 29, 2018 on the transitional provisions that should be created. Following the consultation, the government intends to release draft proposals and transitional administrative guidance.

There will be some transitional issues that existing HWTs will need to consider, including whether it will be possible for existing HWTs to continue as ELHTs without the creation of a new trust, whether and under what conditions a rollover of assets to a new trust will be permitted and the tax implications for a HWT that does not satisfy the conditions to become an ELHT or where the trustees of a HWT choose not to convert.

Stakeholders of current HWTs should be aware that the CRA will no longer apply its administrative policy to existing HWTs after 2020 and any new HWTs created after February 27, 2018 must follow the legislative rules applicable to ELHTs. Furthermore, existing HWTs will likely find more monitoring and oversight will be required in the future to ensure the legislative rules applicable to ELHTs are complied with.

At-risk rules for tiered partnerships

Limited partners of a partnership may only deduct partnership losses allocated to them to the extent of their "at-risk amount"—a calculation that measures the partner's risk in the limited partnership (i.e., it essentially includes the partner's invested capital plus any unpaid partnership income allocated by the partnership). Budget 2018 clarifies that the at-risk rules also apply to a partnership that is itself a limited partner of another partnership.

These changes will apply in respect of taxation years ending on or after February 27, 2018. As a result, tiered partnership structures will need to be reviewed going forward in order to ensure that they are on-side with the at-risk rules.

Personal tax measures

Reporting requirements for trusts

To address the gaps that currently exist with respect to the reporting requirements for trusts, Budget 2018 has proposed that, starting in 2021 and on an annual basis for subsequent taxation years thereafter, certain trusts be obligated to file a T3 return that includes certain specified information—regardless of whether the trust had any income in that particular year. The new rules will require disclosure of information relating to the trust's settlor, trustees and beneficiaries. Most notably, these new reporting requirements will affect inter vivos trusts.

An exception is provided for trusts that have been in existence for less than three months, or that hold less than $50,000 in assets throughout the taxation year, where the assets are limited to deposits, government debt obligations and listed securities. This latter exception will likely not be met in a typical family trust scenario.

Stakeholders to trust arrangements that meet the new reporting requirements will need to be aware of any further guidance or changes that are provided prior to the 2021 implementation date. For discretionary trusts, one question that arises is how the discretionary beneficiaries will be required to be disclosed under this new reporting requirement.

Excise tax

Consultations on the GST/HST holding corporation rules

The government indicated in Budget 2018 that it intends to consult on a Goods and Services Tax/Harmonized Sales Tax (GST/HST) rule, commonly referred to as the "holding corporation rule", which generally allows a parent corporation to claim input tax credits to recover GST/HST paid in respect of expenses that relate to the ownership of shares or indebtedness of another related corporation (which must be a commercial operating corporation).

The government intends to consult on the limitation of this rule to corporations and the required degree of relationship between the parent corporation and the commercial operating corporation. The government also intends to clarify which expenses of the parent corporation are incurred in relation to shares or indebtedness of a related commercial operating corporation, and therefore qualify for input tax credits under the rule.

If you have a holding company owning shares of one or more operating companies, please be aware that this consultation is taking place and consider whether any structural changes are required and whether there are opportunities to charge some of these expenses by way of reasonable management fees.

International tax measures

Reporting requirements and reassessment periods

Taxpayers (and certain partnerships) are required to file an information return, Form T1134, *Information Return Relating to Controlled and Not-Controlled Foreign Affiliates*, each year in respect of each of their foreign affiliates. Currently this return is due within 15 months after the end of the taxpayer's taxation year. Budget 2018 proposes to accelerate this filing deadline to six months after the end of the taxpayer's taxation year (for years that begin after 2019) to be consistent with the corporate income tax filing requirements.

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

Taxpayers with foreign affiliates should be aware of these changes. The new accelerated filing deadline for the T1134s may be difficult to meet as the information required may not be available in time. Interestingly, the budget documents only discuss the change in filing deadline for corporate taxpayers with foreign affiliates; there is no mention of the filing deadline for individuals with foreign affiliates. Hopefully, further information will be provided by the government to clarify the application of the accelerated filing deadline.

Investment businesses

The foreign accrual property income (FAPI) of a foreign affiliate of a taxpayer is included in the taxpayer's income on an accrual basis. FAPI includes the income of a foreign affiliate from an investment business unless the affiliate employs more than five full-time employees or the equivalent in the business.

Planning has therefore evolved to avoid FAPI through "tracking arrangements", whereby taxpayers who would not otherwise meet the more than five full-time employee test on a standalone basis pool their assets into a single foreign affiliate so this test is met. However, economically, each taxpayer retains control over its contributed assets and any returns are determined by reference to their contributed assets.

Where such an arrangement exists, Budget 2018 proposes to treat each underlying activity that accrues to a specific taxpayer as a separate business of the foreign affiliate, and each separate business will need to satisfy the more than five full-time employee test for the affiliate's income to be excluded from FAPI.

This measure will apply to taxation years of a taxpayer's foreign affiliate that begin on or after February 27, 2018.

Taxpayers who are currently involved in such arrangements should be aware of these changes and discuss the potential impact with their tax advisor.