2018 FEDERAL BUDGET – A SUMMARY OF KEY TAX CHANGES

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The latest Federal Budget was tabled by the Liberal government on February 27, 2018. In terms of income tax measures, there were not a significant number of changes. However, the Budget did contain the long awaited rules for passive investment income earned by private corporations. This month's newsletter will summarize these new rules as well as the other tax measures that were outlined in the Budget.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

Passive Investment Income Earned by Private Corporations

Many private corporations in Canada have accumulated passive investments from the retention of business profits. The benefit of investing in a private corporation is the ability to pay lower corporate tax rates on business income and invest the larger pool of after tax funds corporately to accumulate savings for the shareholders.

The original proposals for passive investment income earned by private corporations were first announced in a discussion paper issued by the Department of Finance on July 18, 2017. If enacted, the proposals would have effectively eliminated this deferral benefit. The mechanics of the proposal were complex and the government was not definitive on how exactly the new system would operate. There was an immediate backlash from taxpayers and advisors in response to the proposals. Among the main concerns was the suggestion that the combined corporate and personal tax rates on passive income earned by a corporation and paid out to the shareholders could be as high as 73% for individuals in the top tax bracket. Secondly, the sheer complexity of the rules were considered by some to be unworkable in practice. The government had committed to grandfathering existing corporate investment assets as well and in October of 2017, it committed to allowing $50,000 of passive investment income to be earned annually without being subject to the new, more punitive tax regime.

The current proposals contained in the 2018 Federal Budget are a significant departure from the original proposals. The original proposals have been entirely scrapped and replaced with a proposed system that will reduce a private corporation's access to the small business deduction if its passive investment income (determined on an associated corporation basis) exceeds $50,000 annually. The small business deduction will be reduced on a straight-line basis at a rate of $5 for every $1 of passive investment income in excess of $50,000 and will be entirely eliminated if passive investment income exceeds $150,000.

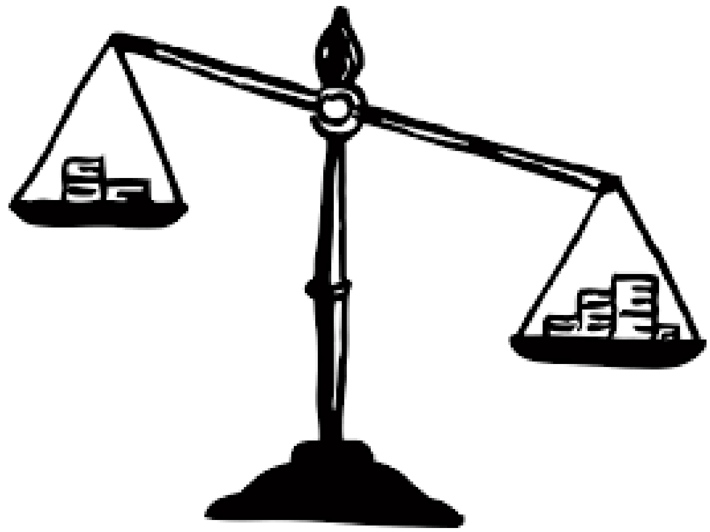
For the purposes of the $50,000 passive investment income amount, a new definition, "adjusted aggregate investment income" ("AAII") will be used. In general, AAII includes:

- Interest, rents and royalties received from non-associated corporations;
- Dividends received from non-connected corporations;
- Taxable capital gains in excess of net capital losses provided that they do not arise from the disposition of assets used principally in an active business carried on primarily in Canada;
- Income from savings in a life insurance policy that is not an exempt policy.

Overall, the new proposals represent a significant softening of the rules when compared to the original proposals. At their worst, the new rules will result in a reduction of the tax deferral from 40% to 27% available on reinvesting business income at the corporate level by possibly subjecting the corporation to 26.5% tax on its business income instead of 13.5%. Gone is the potential 73% combined tax cost. There is no mention of grandfathering existing wealth in the new proposals but given the approach adopted in the new proposals, it seems not to be necessary. For holding corporations that do not earn active income, the new proposals will have no impact on the taxation of their investment income.

The latest proposals will apply to taxation years that commence after 2018.

Refundable Dividend Tax on Hand ("RDTOH")



Under existing legislation, a dividend refund is available to a corporation at the rate of 38.33% of taxable dividends paid to the extent that there is an available balance of RDTOH at the corporation's year-end. The dividends paid can be either non-eligible dividends or eligible dividends. There is a tax advantage where eligible dividends are paid as the effective tax rate to the recipient is generally about 7% less.

The Budget proposes to introduce measures that will allow a CCPC to recoup RDTOH only on the payment of non-eligible dividends. An exception will apply to RDTOH arising on the payment of Part IV tax on eligible portfolio dividends. Such RDTOH can be recouped on the payment of eligible dividends. To accomplish this, the Budget proposes to create an "eligible RDTOH" account and a "non-eligible RDTOH" account.

Eligible RDTOH will include only Part IV tax paid on the receipt of eligible portfolio dividends. All other refundable taxes will be included in the non-eligible RDTOH account. If a corporation pays a non-eligible dividend, it will recover non-eligible RDTOH first before it recoups eligible RDTOH. If it pays an eligible dividend, it can recover eligible RDTOH. Any taxable dividend paid, either eligible or non-eligible, will entitle the corporation to a refund of eligible RDTOH. Special transitional rules will apply to determine the opening balances of eligible and non-eligible RDTOH.

As a result of these rules, in a given taxation year taxpayers may have to choose between the preferential tax rates offered by eligible dividends and the ability to recover refundable taxes if only a non-eligible RDTOH balance exists.

This proposal will apply to taxation years that commence after 2018.

Other Tax Matters of Interest

The Budget confirms that Finance will proceed with the implementation of the December 13, 2017, draft proposals that address income sprinkling involving private corporations. The details of these income sprinkling proposals were summarized in our December 2017 newsletter. These rules took effect January 1, 2018.

The Budget did not contain any significant personal income tax measures. The capital gains inclusion rate will not increase and remains at 50%. In addition, proposals in respect of “surplus stripping” first introduced in July 2017 and then abandoned have not been reintroduced. Personal income tax rates remain unchanged.

The Budget proposes extensive new reporting requirements for most family trusts, effective for 2021 and subsequent taxation years. These requirements could impose an obligation to file a return where none currently exists, such as where the trust earned no income in the year. The trust will be required to report the identity of all trustees, beneficiaries and settlors of the trust. Penalties will apply for failure to file a trust return where the new reporting requirements apply, to a maximum of $2,500 annually. If the failure to file is made knowingly, or as a result of gross negligence, there will be an additional penalty of five per cent of the maximum fair market value of property held during the year with a minimum of $2,500. As a result of these changes, we recommend that all family trusts file tax returns on an annual basis to avoid the possible application of penalties. We will provide further commentary on these proposals as more information becomes available.

The Budget also proposes to shorten the filing deadline for the foreign affiliate information reporting (T1134) from the current 15 months after the taxpayer’s yearend to 6 months after the yearend. This proposal applies to taxation years that begin after 2019.

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