February 27, 2018

CALU Special Report

Budget 2018: Government continues its commitment to the middle class

Highlights

- A new and less complex approach to dealing with passive investment income within a private corporation
- A strong push for gender equity both in Canada and internationally
- A continued focus on aggressive tax planning strategies both domestically and internationally
- A renewed focus on supporting the indigenous people of Canada
- Implementation of a national pharmacare strategy

Introduction

On February 27, 2018, Finance Minister Morneau tabled his third budget ("Budget 2018"), entitled "Equality + Growth: A Strong Middle Class." This budget continues to be influenced by very similar political, financial and economic forces as in prior budgets, namely: large federal deficits; the need to stimulate job growth and innovation; supporting the growth of the middle class; navigating the impact of major tax changes and growing trade protectionism in the United States. The Government expresses its desire to address pay equity for federally-regulated organizations and support women in assuming a greater role in business, executive management and government.

This CALU *Special Report* reviews the policy frameworks underlying the budget and provides information about tax proposals of greatest interest to CALU members.

The Current Fiscal Position

Budget 2018 highlights the strong performance of the Canadian economy over the past 2.5 years, noting that the unemployment rate has fallen from 7.1 per cent to 5.9 per cent, close to its lowest level in over four decades. . Canada's GDP growth since early 2016 through to late 2017 has been 3.2 per cent, outstripping the growth of all other G7 countries. It is noted however that future economic growth is harder to predict and is at least partially dependent on the future of the North American Free Trade Agreement.

From a deficit position, the government continues to focus on the net federal debt to GDP ratio, where again Canada's performance is the lowest in relation to other G7 countries and less than half the G7 average.

The federal deficit shows significant improvements over Budget 2017, with the 2017-18 deficit now forecast to be $19.4 billion vs the $28.5 billion predicted in last year's budget. Unfortunately, there is still no light at the end of the tunnel, with annual federal deficits continuing through to at least 2022-23, when it is projected to decline to $12.3 billion. However, it is pointed out that by the end of 2023 the federal debt to GDP ratio will have continued its downward trajectory, even using the most conservative private sector economic forecasts for GDP growth.

Major Budget Themes

Budget 2018 outlines five key themes that will underpin the Government's future priorities:

1. **Supporting Growth in Canada**
   - Continuing to support the middle class (see discussion below)
   - Creating greater equity in the workforce
   - Assisting Canadians in developing the necessary skills for tomorrow's economy
   - Strengthening and diversifying international trade
   - Creating a fairer tax system (see discussion below)

2. **Supporting Innovation and Entrepreneurship**
   - Investing in Canadian scientists and researchers
   - Federal collaboration with business and entrepreneurs
   - Enhancing the role and collaborative efforts of federal science programs

3. **Reconciliation with Indigenous Peoples**

   The government announced a number of initiatives to support the indigenous peoples and support their rights to self-determination and self-government.

4. Advancing the Shared Values of Canadians Nationally and Internationally

- Protecting Canada's national resources
- Advancing gender equity in the international forum
- Supporting the health and wellness of Canadians (see discussion below)
- Taking steps to enhance federal governance processes
- Improving client services at the Canada Revenue Agency
- Enhancing individual security and access to justice (see discussion below)

5. Equality

A number of initiatives were announced to support the federal government's commitment to gender equity, assistance for low income Canadians and advancing reconciliation with indigenous peoples.

What's Not in the Budget

Budget 2018 does not contain any new tax measures relating to the following areas:

- Tax treatment of exempt life insurance policies;
- Rules governing the capital dividend account;
- Individual or corporate tax rates;
- Tax treatment of capital gains;
- Taxation of group life and health benefits (but see the discussion below on Health and Welfare Trusts and National Pharmacare);
- Tax rules relating to any registered plans (i.e. TFSAs, RESPs, RDSPs, RRSPs, RPPs);
- Rules in section 84.1 relating to intergenerational business transfers;
- Modifications to the proposed tax on split income (TOSI) rules.

Business Income Tax Measures

Passive Investment Income in a Private Corporation

Private corporation owners will breathe a sigh of relief with Budget 2018 proposals to address passive investment income in their corporations. Readers will recall the July 18, 2017 consultation paper which contained suggested proposals to address the perceived unfair advantage of earning passive investment income in private corporations and could result in overall tax on such income at a rate as high as 73 per cent. After the many submissions by small businesses, small business interest groups, and tax advisors, including CALU and its members, and consultations by the Department of Finance, it was determined that the former proposals could be very complex and add significant burden to the very small businesses the government wants to support.

While Finance is continuing with proposals to address this perceived unfairness, they are more targeted and have been applied in a simpler manner. Specifically, Budget 2018 is proposing two measures to address passive investment income in a private corporation that will come into effect for taxation years that begin after 2018 (subject to an anti-avoidance transitional rule described below). While the proposals are included in the Notice of Ways and Means Motion released with the budget materials, it also contains a provision indicating that further amendments may be released to give effect to the proposals.

Limiting Access to the Business Limit

CCPCs earning qualifying active business income are generally entitled to a preferential rate of tax on that income up to $500,000 (the business limit). As announced by Finance in October 2017, the federal rate on such income was reduced to 10.5 per cent in 2018 and will be reduced to 9 per cent in 2019 (compared to the federal general rate of 15 per cent).

The business limit of a CCPC is reduced under the current rules where the taxable capital employed in Canada by the CCPC and associated corporations exceeds $10 million (and is eliminated when it reaches $15 million).

Budget 2018 proposed to provide for an alternative reduction to the business limit where a CCPC and its associated corporations have investment income in the year exceeding $50,000 (and is eliminated when the investment income reaches $150,000). The amount of the reduction is $5 for every $1 of investment income exceeding $50,000. In effect, the business limit reduction will be the greater of that determined under the capital test above and this new investment income test.

For example, assume a CCPC with no associated corporations has taxable capital employed in Canada of $5 million and earns investment income of $100,000 in a particular year. The business limit is reduced by the greater of: (a) $0 (as the taxable capital does not exceed $10 million there is no reduction under the capital test), and (b) $250,000 (being $5 x ($100,000 - $50,000)).

Important to the application of this new business limit reduction is an assessment of the CCPC's investment income. For these purposes, a new term "adjusted aggregate investment income" is being introduced which is, in effect, the current "aggregate investment income", as already defined and utilized in the Act, with the following adjustments:

- Taxable capital gains (and losses) are excluded to the extent they arise from the disposition of: (i) property used in the active business carried on in Canada by the CCPC, or (ii) shares of another CCPC connected with the CCPC where all or substantially all of the assets of the other CCPC are used in an active business carried on in Canada.
- Net capital losses carried over from another taxation year are excluded.
- Dividends from non-connected corporations are added.
- Income from a non-exempt life insurance policy are added, if not otherwise in aggregate investment income.

Note that annuity contracts used as part of a life insurance strategy or otherwise can impact the CCPCs access to the small business tax on its business income. As well, gains from the disposition of exempt insurance policies will be included in adjusted aggregate investment income.

Included in the proposals is an anti-avoidance rule that will deem two corporations to be associated if they are related to each other, one corporation has lent or transferred property to the other corporation (directly or indirectly, by means of a trust or any other means), and it is reasonable to consider that the reason for the loan or transfer of property was to reduce the adjusted aggregate investment income of the lending or transferring corporation.

While intended to apply to taxation years that begin after 2018, the proposals contain a transitional rule that will apply the alternative business limit reduction to a CCPC's taxation year that begins before 2019 and ends after 2018 if a transaction was implemented to cause a short taxation year to defer the application of the new proposals.

Refundable Taxes on Investment Income

Under the current rules, private corporations are entitled to claim a tax refund equal to $38.33 for every $100 of taxable dividend paid (subject to having a balance in its refundable dividend tax on hand (RDTOH) account). Where the corporation has a combination of regular business income (taxed at the regular business rate which does not include a refundable tax element) and investment income (taxed at the corporate investment rate which includes a refundable tax component), planning was commonly implemented to have the business income distributed by way of eligible dividend (taxed at a lower rate) while still being able to claim the tax refund.

Budget 2018 proposes to modify the refundable tax regime to eliminate this planning and ensure that, in general, the private corporation is entitled to a dividend refund only when non-eligible dividends are paid. This will be accomplished by having two RDTOH accounts on a go-forward basis: (1) eligible RDTOH which will consist of Part IV tax paid on eligible dividends on portfolio investments; and (2) non-eligible RDTOH which will consist of refundable taxes paid under Part I (i.e., on regular investment income other than dividends from Canadian corporations) and Part IV tax paid on non-eligible dividends on portfolio investments. Where Part IV tax is payable on dividends received from a connected corporation, the tax will be added to the RDTOH account from which the payor corporation receives the refund.

A CCPC's existing RDTOH (for the year ended before the taxation year that begins after 2018), will be allocated to the eligible RDTOH in an amount equal to the lesser of the RDTOH balance and 38-1/3 per cent of its general rate income pool (GRIP). Any remaining RDTOH will be allocated to the non-eligible RDTOH.

For any other corporation, the entire RDTOH balance will be allocated to the eligible RDTOH.

On the payment of non-eligible dividends, the corporation will be entitled to a dividend refund only from the non-eligible RDTOH unless there is insufficient non-eligible RDTOH; in that circumstance, the "excess" can create a dividend refund from the eligible RDTOH. Eligible dividends will permit the corporation to claim a dividend refund from the eligible RDTOH. As a result of these proposals, a private corporation will no longer be able to claim a dividend refund on the payment of eligible dividends sourced from the active business earnings of the corporation.

While intended to apply to taxation years that begin after 2018, these proposals will apply to the taxation year that begins before 2019 and ends after 2018 if a transaction was implemented to cause a short taxation year to defer the application of the new proposals.

At-Risk Rules for Limited Partnerships

In general, a limited partner of a limited partnership (LP) can only deduct the losses allocated from the LP to the extent of its "at-risk" amount (the amount of capital contributed to the LP plus undistributed income of the LP allocated to the limited partner). Any denied loss can be carried forward and claimed as the "at-risk" amount increases (i.e., when additional capital is contributed or future profits are allocated) or added to the adjusted cost based of the LP interest when sold.

While Finance intended that these rules would apply in a similar fashion where the limited partner is another partnership, a recent Federal Court of Appeal decision has put this into question. As a result, Budget 2018 proposes to amend the Act to ensure that the "at-risk" rules apply to partnerships that are limited partners.

Insurance Tax Measures

Health and Welfare Trusts

A Health and Welfare Trust (HWT) is a trust established by an employer to provide 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 Act). Instead, the Canada Revenue Agency (CRA) has published administrative positions regarding the requirements for qualifying as a HWT along with rules relating to contributions to, and the computation of taxable income of, such a trust. However, the tax treatment of health benefits paid to employees is set out in the Act.

The Employee Life and Health Trust (ELHT) rules were added to the Act in 2010. An ELHT also provides health benefits for employees – group sickness or accident insurance plans, private health services plans and group term life insurance policies. While the ELHT rules are very similar to the CRA's administrative positions for HWTs, the ELHT rules deal with certain issues (e.g., the treatment of surplus income and pre-funding of benefits) that are not dealt with in the administrative HWT regime.

Budget 2018 proposes that only one set of rules apply to these arrangements. The CRA will therefore no longer apply their administrative positions with respect to existing HWTs *after the end of 2020,* or to HWTs *established after February 27, 2018*. Transitional rules will be provided to facilitate the conversion of existing HWTs to ELHTs. HWTs that are not converted (or wound up) to an ELHT will be subject to the normal income tax rules for inter vivos trusts. In addition, the CRA will announce transitional administrative guidance relating to winding-up existing HWTs.

Finance has invited taxpayers to provide input before June 29, 2018 on transitional issues, both administrative and legislative, to facilitate the discontinuation of the HWT regime. Following this consultation, Finance intends to release draft legislative proposals and transitional administrative guidance.

Review of National Pharmacare

Budget 2018 notes that at least one in ten Canadians cannot afford prescription drugs, and that almost one million Canadians give up food and heat to afford medicine. And those who can afford to pay for their drugs face some of the highest costs among the world's most advanced countries. The unaffordability of many medications leads to Canadians being less healthy, with significantly higher health care costs for us all.

As part of Budget 2018, the Government has announced the creation of an Advisory Council on the Implementation of National Pharmacare. The Advisory Council will report to the federal Minister of Health and the Minister of Finance and will conduct an economic and social assessment of domestic and international models and will recommend options on how to move forward on a national pharmacare program.

It is too early to predict what form this model might take, but CALU will continue to reinforce the benefits of the current private insurance model as an important component of the pharmacare system for the future.

Personal Tax Measures

Canada Workers Benefit

The 2017 Fall Economic Statement announced the Government's intention to enhance the benefits provided by the Working Income Tax Benefit starting in 2019. Budget 2018 proposes to rename the program to the Canada Workers Benefit (CWB). Starting in 2019 the amount of the CWB will be equal to 26 per cent of each dollar of earned income in excess of $3,000 to a maximum annual benefit of $1,355 for single individuals without dependants, and $2,335 for families (couples and single parents). The benefit will be reduced once the adjusted net income for a single individual without dependants exceeds $12,820, and where adjusted net income exceeds $17,025 for families. The benefit will be eliminated for single individuals without dependants with approximately $24,000 of adjusted net income in the year, and for families with approximately $37,000 of combined net adjusted income in the year.

Individuals who are eligible for the Disability Tax Credit may also receive a CWB disability supplement. Budget 2018 proposes that the maximum amount of the disability supplement will be increased to $700 in 2019, and the phase-out threshold of the supplement will be increased to $24,111 for single individuals without dependants and to $36,483 for families with dependants.

Registered Disability Savings Programs

Where the capacity of an adult individual to enter into a Registered Disability Savings Program (RDSP) is in doubt, the Act requires that the plan holder of the individual's RDSP be the individual's legal representative, as recognized under provincial or territorial law.

Establishing a legal guardian or other representative can be a lengthy and expensive process. Some provinces and territories have either instituted streamlined processes that allow for the appointment of a trusted person to manage resources on behalf of an adult who lacks contractual capacity, or their system already provides sufficient flexibility to address this concern. Other provinces have indicated they require more time to develop such a process.

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 currently set to expire at the end of 2018.

Budget 2018 proposes to extend the temporary measure by five years, to the end of 2023. A qualifying family member who becomes a plan holder before the end of 2023 will be able to remain the plan holder after 2023.

The federal government would like those provinces and territories currently without streamlined processes to examine whether they can develop a long-term solution to address RDSP legal representation issues.

Deduction of Enhanced QPP Contributions

To provide consistent income tax treatment of Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) contributions, Budget 2018 proposes to provide a deduction for employee contributions (as well as the "employer" share of contributions made by self-employed persons) to the enhanced portion of the QPP.

Since contributions to the enhanced portion of the QPP will begin to be phased in starting in 2019, this measure will apply to the 2019 and subsequent taxation years.

Donations to Universities Outside Canada

Canadians may claim the charitable donation tax credit or deduction for donations made to registered charities and other "qualified donees". Universities outside Canada are eligible to be recognized as qualified donees if they can demonstrate, among other things, their student body ordinarily includes students from Canada. Qualifying universities outside Canada are included in Schedule VIII to the *Income Tax Regulations*.

Certain categories of qualified donees, including universities outside Canada, are now required to register with the CRA, and to meet certain receipting and record-keeping conditions. Once these qualified donees are registered, public notification is provided by listing them on the Government of Canada's website. As a result of this registration processes, qualifying universities outside of Canada are required to be added to two separate, identical lists.

To simplify the administration of these rules and streamline the registration process for universities outside Canada as qualified donees, Budget 2018 proposes to remove the requirement that universities outside Canada be prescribed in the *Income Tax Regulations*. This measure will apply as of Budget Day.

Mineral Exploration Tax Credit

Flow-through shares allow resource companies to renounce or "flow through" tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income. The mineral exploration tax credit provides an additional income tax benefit for individuals who invest in mining flow-through shares, which augments the tax benefits associated with the deductions that are flowed through. This credit is equal to 15 per cent of specified mineral exploration expenses incurred in Canada and renounced to 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. Under the existing "look-back" rule, funds raised in one calendar year with the benefit of the credit can be spent on eligible exploration up to the end of the following calendar year. Therefore, for example, funds raised with the credit during the first three months of 2019 can support eligible exploration until the end of 2020.

Reporting Requirements for Trusts

A trust that does not earn income or make distributions in a year is generally not required to file an annual T3 return of income. Even if a trust is required to file a return of income for a year, there is no requirement for the trust to report the identity of all its beneficiaries. Given the absence of an annual reporting requirement, and the limitations with respect to the information collected when reporting is required, there are concerns that this can lead to significant gaps with respect to the trust information that is available to the CRA.

Budget 2018 therefore proposes to require that certain trusts provide additional information on an annual basis. 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 made in writing (as opposed to a resulting or constructive trust, or certain trusts deemed to arise under the provisions of a statute). The following types of trusts will not be subject to these additional reporting requirements:

- mutual fund trusts, segregated funds and master trusts;
- trusts governed by registered plans (i.e., DPSPs, PRPPs, RDSPs, RESPs, RPPs, RRIFs, RRSPs, TFSAs);
- 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 (e.g., a protector).

These proposed new reporting requirements will apply to returns required to be filed for the 2021 and subsequent taxation years. Budget 2018 also proposes to introduce new penalties for a failure to file a T3 return, including a required beneficial ownership schedule, in circumstances where the schedule is required. If a failure to file the return was made knowingly, or due to gross negligence, an additional penalty will apply. As well, existing penalties will continue to apply. The new penalties will apply in respect of returns required to be filed for the 2021 and subsequent taxation years.

International Tax Measures

Extended Reassessment Period for Foreign Affiliate Income

Budget 2018 proposes to extend by three years the normal reassessment period of a taxpayer, but only in respect of income arising in connection with a foreign affiliate. This is necessary to provide the CRA with ample time to collect and review often complex information in an audit of a foreign affiliate.

This proposal applies to taxation years that begin on or after February 27, 2018.

New Foreign Affiliate Reporting Due Date

Since the late 1990s taxpayers have been required to file a separate information return to report interests in, and specific information about, foreign affiliates and controlled foreign affiliates (Form T1134). These information returns are due 15 months after the taxation year end of the taxpayer (a date later than the filing due dates). Because the information contained in those information returns are important to properly assessing a taxpayer's income tax return, Budget 2018 proposes to change the filing due date for Form T1134 to six months after the end of the taxpayer's taxation year.

This proposal applies to taxation years that begin after 2019, but there were no detailed legislative changes included in the Notice of Ways and Means Motion.

Spending and Other Measures of Interest

The Government has proposed a number of new spending measures, the following of which may be of interest to CALU members:

- $1.2 billion over the next five years to introduce a new EI Parental Sharing Benefit. This benefit will provide additional weeks of parental benefits, when both parents agree to share parental leave. This benefit is expected to start in June 2019.
- The Tax Court of Canada will receive additional funding of almost $42 million over the next five years to ensure it can handle a growing and increasingly complex caseload.
- Over $90 million will be provided over the next five years to the CRA to further combat tax evasion and tax avoidance. In connection with the CRA's activities on aggressive tax avoidance, the Government stated that it has imposed $44 million in penalties against third parties who promote tax avoidance schemes.
- $11.5 million will be provided over the next three years to allow the federal government to pursue a regulatory reform agenda focused on supporting innovation and business investment.
- Over $200 million to the CRA over the next five years to improve telephone services, enhance the Community Volunteer Income Tax Program, and strengthening digital services.
- $30 million to the CRA over the next five years to enhance the security measures to protect the confidential information of taxpayers.

- There have been several well publicized corporate insolvencies (i.e. Nortel and Sears Canada) where the pension plan had substantial unfunded pension liabilities. This has put the retirement incomes of workers and pensioners at risk. The federal government has indicated that it will undertake a review to determine how best to protect workers and pensioners while recognizing the competing demands of creditors under bankruptcy proceedings.

Conclusion

As noted, most business owners (and their professional advisors) can give a collective sigh of relief with the reformed passive investment rules. Other than these legislative proposals, Budget 2018 was a bit of yawner from a tax perspective. But the federal government has announced plans to embark on some ambitious programs including a number of measures relating to gender equity, creating a national dialogue on a national pharmacare program, and investments in a number of priority initiatives. CALU will continue to play a productive role by engaging in dialogue and debate with the federal government and other interested stakeholders on those issues of critical interest to our members and their clients.

About CALU

The Conference for Advanced Life Underwriting (CALU) is a national professional membership association of established financial advisors (life insurance, wealth management and employee benefits), accounting, tax, legal and actuarial professionals. For more than 25 years CALU has engaged in public policy advocacy relating to advanced planning issues on behalf of its members and the members of its sister organization, Advocis, The Financial Advisors Association of Canada. Through these efforts, CALU represents the interests of some 13,000 insurance and financial advisors and in turn the interests of millions of Canadians. For more information please visit www.calu.com.