2018 Federal Budget

Jamie Golombek and Debbie Pearl-Weinberg
Tax & Estate Planning, CIBC Financial Planning and Advice

The February 27, 2018 federal budget (the "Budget") included a number of tax measures that will impact Canadian taxpayers. Rather than summarize every tax measure included in the Budget document, this report, which was prepared from within the Budget lock-up in Ottawa, will focus on some of the tax measures that are of most interest to individuals and small business owners.

Canadian Controlled Private Corporation (CCPC) Tax Changes: Passive Investment Income

In last year's federal budget, the government announced that it was conducting a review of tax planning strategies involving private corporations. The Department of Finance released a paper in July 2017 outlining three areas of concern: income sprinkling using private corporations, converting a private corporation's regular income into capital gains and passive investments inside private corporations. The government announced in October 2017 that they were not proceeding with the proposals regarding converting regular income to capital gains. The income sprinkling proposals were revised in December 2017 and detailed rules concerning restricting the earning of passive investment income inside a corporation were to be released as part of the 2018 federal budget. Last fall, the government stated that investments already made inside of private corporations, including the future income earned from such investments, would be protected. The rules were to apply only on a go-forward basis and the first $50,000 of passive income annually would not be subject to the new rules.

During the period of consultation, the government heard that its proposals, which would have taxed investment income inside a corporation at punitive effective tax rates, could be very complex and the tracking of pre- and post-grandfathered assets would add significant administrative burdens on businesses. Consistent with the government's outlined principles and consistent with the helpful contributions of many Canadians in the consultation period, the government decided to take an entirely different approach and instead proposed two new measures to limit deferral advantages from holding passive savings in a corporation, but in a more targeted and simpler manner than was proposed in July 2017.

Tax Deferral Advantage

The government's concern is that under the current rules, a "tax deferral advantage" exists because the tax rate on active business income earned in a corporation is generally much lower that the top marginal tax rate for individuals earning business income or employment income directly. If this after-tax corporate business income is not needed for a shareholder's living expenses and is retained in the corporation, there is more after-tax income to be used as capital for investment than there would be if the business income was earned by the individual.

If these corporate funds are invested for a sufficiently long period of time, shareholders may end up with a higher after-tax amount than if income was earned directly by the individual shareholder and invested in the shareholder's hands, due to the larger amount of starting capital to invest. The purpose of the passive investment income proposals is to remove some of this tax deferral advantage.

The size of the tax deferral advantage depends on the difference between the applicable corporate tax rate and the shareholder's personal tax rate.

Federally, the first $500,000 of active business income is taxed at the small business deduction tax rate (SBD Rate), which is a lower tax rate than the general corporate tax rate on active business income (ABI); thus, the tax deferral advantage is magnified for small business income and the deferral ranges from 35.3% to 41.0% in 2018, as shown in Figure 1. For ABI, the tax deferral advantage ranges from 20.4% to 27.0%

Figure 1: 2018 Tax Deferral Advantage by Province for SBD Income and ABI

	SBD Income (eligible for small business deduction)	ABI (not eligible for small business deduction)
BC	37.8%	22.8%
AB	36.0%	21.0%
SK	35.5%	20.5%
MB	40.4%	23.4%
ON	40.0%	27.0%
QU	35.3%	26.6%
NB	40.8%	24.3%
NS	41.0%	23.0%
PE	36.9%	20.4%
NL	38.3%	21.3%

The Proposed Rules

The Budget proposes two measures to address the tax deferral advantage. The first impacts eligibility for business income to be taxed at the lower SBD Rate. The second measure restricts payouts from the refundable dividend tax on hand (RDTOH) account for larger CCPCs. Both of these measures would be effective beginning January 1, 2019.

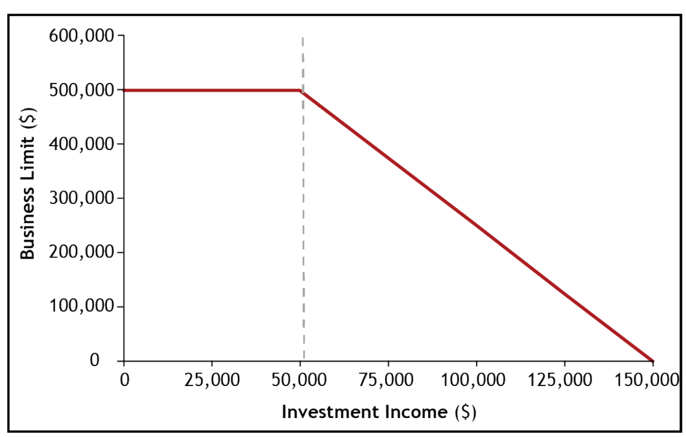
Restricting the SBD Rate

The SBD Rate currently applies federally on the first $500,000 of qualifying active business income of a CCPC. This is referred to as the "Business Limit." The first new measure proposes to reduce the Business Limit for CCPCs with over $50,000 of "*adjusted aggregate investment income*"[1] in a year, and to reduce the Business Limit to zero once $150,000 of adjusted aggregate investment income is earned in a year.

Essentially, in certain circumstances this proposed measure will limit the tax deferral advantage available on "new" ABI to the difference between the personal tax rate on ordinary income and the tax rate on ABI earned in a corporation that is *not* eligible for the SBD Rate.

Figure 2 illustrates the interaction between adjusted aggregate investment income and the impact on the Business Limit.

Figure 2: Reduction in the Small Business Deduction Limit Based on Passive Investment Income



Source: Finance Canada, Budget Plan 2018

Examples of New Passive Investment Income / SBD Limitation Rules

The following examples are adapted from the *2018 Budget Plan* and demonstrate how the new rules may affect a small business owner in 2019.

Example 1

Elise owns an incorporated catering business which earns $100,000 (after tax) annually and pays out $75,000 as non-eligible dividends each year. She retains the extra $25,000 annually to build up a fund for a planned parental leave. Elise will not be affected by the new rules since the investment income on her savings will be well below the $50,000 annual threshold. Thus, she will have no income taxed at the general corporate rate.

Example 2

Simon is an incorporated farmer who puts aside excess funds annually to manage weather and other risks affecting his livelihood. His goal is to save $500,000. He chooses to save through his corporation in the AgriInvest program to take advantage of matching government contributions. Investment income from AgriInvest is not considered adjusted aggregate investment income. As such, Simon will not be affected by the new rules.

Example 3

Claire owns a retail business and now uses the retained earnings in her corporation to invest in promising start-ups. She recently sold a 20-per-cent stake in a growing clean-tech firm, and realized a $1 million capital gain, which she reinvested into two new start-ups. Claire also won't be affected by the new rules because her ownership stake in the active business she just sold is such that her capital gain will not count towards the $50,000 threshold, and she is actively reinvesting.

Example 4

Amrita owns a hotel whose income depends on a number of factors outside her control, so she sets aside funds each year to ensure she can continue to pay salaries and expenses in case of a downturn. She has $400,000 in savings in her corporation that she invests in low-risk bonds. Amrita will not be affected by the new rules because the investment income on her savings will be well below the $50,000 threshold, and therefore she won't have business income taxed at the general corporate rate.

Example 5

Saanvi owns a retail store and keeps cash deposits to pay her suppliers and the salary of her employee. She earns interest income on these deposits, which in her circumstances is considered incidental to her business. As a result, Saanvi will not be affected by the new rules.

Example 6

Louis operates a successful medical practice, which is incorporated and earns more than $500,000 annually. He has accumulated a portfolio with a value of $5 million, which he intends to pass on to his children. Given his level of savings and level of income, beginning in 2019, Louis will no longer receive the benefit of the small business rate to fund further passive investments. All of his business' income will be taxed at the general corporate rate.

Alternative Corporate Investment Strategies: Corporate Owned Life Insurance & Individual Pension Plans

A corporation may choose to invest its after-tax income in a permanent life insurance policy that insures the life of someone, typically the owner-manager. While the Budget specifically captures income from a non-exempt policy in the $50,000 annual passive income test, it appears that an "exempt policy", where no income is required to be included in the holder's income over the life of the policy, does not appear to come under the ambit of these new proposals. This could be a strategy for business owners to consider in consultation with their tax advisors.[2]

An Individual Pension Plan (IPP) is created for one person, rather than a large group of employees.[3] Since the corporation contributes to the IPP and the income earned in the IPP does not belong to the corporation, it too should not be subject to the proposed rules. An IPP could be a strategy to consider once adjusted aggregate investment income exceeds the $50,000 threshold.[4]

Limiting Access to Refundable Taxes for Larger CCPCs

The second proposed measure will limit tax advantages that larger CCPCs can obtain through the RDTOH system.

The tax system is designed to tax investment income earned by CCPCs at a higher rate, which is approximately equal to the top personal income tax rate. A portion of this high rate tax is then refundable when that investment income is paid out to shareholders as a dividend. This refund is made through the RDTOH account system.

In practice, however, any taxable dividends paid by a private corporation can trigger this refund of refundable taxes paid on investment income, regardless of the source of that dividend. In other words, currently, a dividend refund can be obtained irrespective of whether the income is coming from investment income or lower-taxed ABI.

This means that larger CCPCs (who may not have much, if any, ABI taxed at the SBD Rate) can pay out lower-taxed dividends from their pool of ABI taxed at the general corporate rate, and still claim a refund of taxes paid on their investment income which is intended to be taxed at higher tax rates. The government noted that this can provide a significant tax advantage and therefore the Budget proposes that CCPCs will generally no longer be able to obtain refunds of taxes paid on investment income while distributing dividends from income taxed at the general corporate rate. Refunds will continue to be available when investment income is paid out. This will be accomplished by establishing two new RDTOH accounts.

Personal Tax Measures

Canada Workers Benefit (Replacing the Working Income Tax Benefit)

The current Working Income Tax Benefit (WITB) is a refundable tax credit that supplements the earnings of low-income workers and improves work incentives for low-income Canadians.

The Budget proposes to rename the WITB to the Canada Workers Benefit and announced that, for 2019, the amount of the benefit will be enhanced and equal to 26 per cent of each dollar of earned income in excess of $3,000 to a maximum benefit of $1,355 for single individuals and $2,335 for families (couples and single parents). The benefit will be reduced by 12 per cent of adjusted net income in excess of $12,820 for single individuals and $17,025 for families.

Individuals eligible for the Disability Tax Credit (DTC) may also receive a Canada Workers Benefit disability supplement. The Budget proposes that the maximum amount of the Canada Workers Benefit disability supplement be increased to $700 in 2019, and the phase-out threshold of the supplement be increased to $24,111 for single individuals and to $36,483 for families. The reduction rate of the supplement will be decreased to 12 per cent to match the proposed rate for the basic benefit, and to 6 per cent where both partners in a family are eligible for the supplement.

Medical Expense Tax Credit - Psychiatric Service Dogs

The Medical Expense Tax Credit (METC) is a 15-per-cent federal non-refundable tax credit that recognizes the effect of above-average medical and disability-related expenses on an individual's ability to pay tax. For 2018, the METC is available for qualifying medical expenses in excess of the lesser of $2,302 and three per cent of the individual's net income. The provinces and territories also provide a provincial / territorial medical expense credit. Each year, the government reviews the list of eligible expenses to take into account new medical or disability-related developments. Under current rules, the METC provides some tax relief for certain expenses incurred for an animal specially trained to assist a patient in coping with various disabilities, including blindness, profound deafness, and severe autism, diabetes or epilepsy. Qualifying expenses include the cost of the animal as well as costs for the animal's care and maintenance, including food and veterinary care.

The Budget expands the eligibility of the METC to include psychiatric service animals, which "can play an important role in helping Canadians cope with conditions like post-traumatic stress disorder… [and] will directly benefit veterans and others in the disability community who rely on psychiatric service dogs."

These animals are specifically trained to perform tasks for a patient with a severe mental impairment and may include guiding a disoriented patient, searching the home of a patient with severe anxiety before they enter and applying compression to a patient experiencing night terrors. Expenses for an animal that provides comfort or emotional support but that has not been specially trained to perform the tasks described above will not be eligible.

Registered Plans

Registered Education Savings Plan (RESPs)

RESPs allow for tax-efficient savings for children's post-secondary education. The federal government provides a Canada Education Savings Grant (CESG) equal to 20% of the first $2,500 of annual RESP contributions per child or $500 annually with a lifetime maximum of $7,200 per beneficiary.

Last summer, the C.D. Howe Institute suggested[5] that the government establish auto-enrolment in social programs to increase participation, specifically citing as an example our underutilized Canada Learning Bond (CLB) program. This program offers grants to low-income parents who open RESPs for their kids. The CLB can reach a total value of $2,000 per child toward higher education payments without the parents ever having to contribute their own money. The report cites the British equivalent to this program having a take-up rate of nearly 100 per cent of the target population because of its automatic enrolment feature. Meanwhile, Canada's CLB program reaches just 32 per cent of the families it seeks to help.

The government announced that it is working with the Province of Ontario to integrate RESP referrals into the Ontario online birth registration service, meaning more children from low-income families will be able to access the CLB. Parents will be able to open an RESP at the same time as they apply for other services under the Ontario online birth registration service. Once an RESP is open, eligible children will automatically be able to receive the CLB into their RESP without any contributions required by their parents or others.

Registered Disability Savings Plans (RDSPs)

The RDSP is a tax-deferred registered savings plan open to Canadians eligible for the DTC. Up to $200,000 can be invested in the plan. While contributions are not tax-deductible, all earnings and growth accrue tax-deferred until withdrawn from the plan.

Federal government assistance in the form of matching Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs) may be deposited directly into the plan up until the year the beneficiary turns 49. The government will contribute up to a maximum of $3,500 CDSG and

$1,000 CDSB per year of eligibility, depending on the net income of the beneficiary's family.

Under the current rules, when an RDSP is set up for a beneficiary who is over the age of majority, the plan holder must be either the beneficiary or, if the beneficiary lacks the capacity to enter into a contract, the beneficiary's guardian or other legal representative.

Where the capacity of an adult individual to enter into a contract is in doubt, the tax rules require that the plan holder of the individual's RDSP be the individual's legal representative, as recognized under provincial or territorial law; however, establishing a legal guardian or other representative can be a lengthy and expensive process that can have significant repercussions for individuals.

While some provinces and territories have 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 have indicated that their system already provides sufficient flexibility to address this concern, others 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. While this measure was supposed to expire at the end of this year, the Budget proposes to extend this rule by five years, to the end of 2023. A qualifying family member who becomes an RDSP plan holder before the end of 2023 could remain the plan holder after 2023.

Tax Enforcement & Administration

Cracking Down on Tax Evasion and Combatting Tax Avoidance

The government continues to crack down on tax evasion and tax avoidance, with a particular focus on wealthy individuals with offshore accounts.

Over the last two years, the government reviewed all large money transfers between Canada and eight countries of concern, reviewing some 187,000 transactions totalling $177 billion that merited closer scrutiny. Currently, there are over 1,000 offshore audits underway and more than 40 criminal investigations with links to offshore transactions.

The Budget announced that to further combat tax evasion and tax avoidance, it will invest $90.6 million over five years to address additional cases that have been identified through enhanced risk assessment systems, both domestically and internationally. It estimates that this will bring in $354 million of additional federal tax revenue over five years.

Increased Reporting Requirements for Trusts

Under current rules, a trust that does not earn income nor make any distributions to its beneficiaries in a year is generally not required to file an annual T3 Trust Return. Even when a trust is required to file a return, there is no current requirement for the trust to report the identity of all of its beneficiaries.

According to the government, "Better information on who owns which legal entities and arrangements in Canada — known as 'beneficial ownership information' — will help authorities to effectively counter aggressive tax avoidance, tax evasion, money laundering and other criminal activities."

The Budget announced that starting in 2021, certain trusts[6] will be required to provide additional information to the CRA on an annual basis. Trusts that have been in existence for less than three months or that hold less than $50,000 in deposits, government debt obligations and listed securities throughout the taxation year are exempt.

The new reporting requirements will impose an obligation on certain trusts to file a T3 return where one does not currently exist. This information would be used to help the CRA assess the tax liability for trusts and its beneficiaries.

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 distribution of income or capital of the trust (sometimes referred to as a "protector").

To support the collection and processing of all this new trust information, the Budget proposes to provide funding of $79 million over a five-year period and $15 million on an ongoing basis to the CRA in order to support the development of an electronic platform for processing T3 trust returns.

New penalties for a failure to file a T3 return will also be introduced, including penalties for failure to file a beneficial ownership schedule in circumstances where the schedule is required. The penalty will be equal to $25 for each day of delinquency, with a minimum penalty of $100 and a maximum penalty of $2,500. Deliberately not filing a trust return can lead to an additional penalty equal to five per cent of the maximum fair market value of property held during the relevant year by the trust, with a minimum penalty of $2,500.

Improving Client Service at the Canada Revenue Agency

Each year, the CRA answers roughly 20 million calls. Yet Canadians are continuously frustrated by frequent busy signals, dropped calls and long wait times on hold.

In November 2017, the Office of the Auditor General issued a report[7] on the performance of the CRA's call centre, which tested the accuracy of call centre agents and found that they gave wrong information nearly 30% of the time — and that's assuming your call is actually answered.

The Budget acknowledged that "Canadians continue to face unacceptable delays and challenges in dealing with the CRA" and that more needs to be done to make the CRA call centre more helpful and easier to use.

To this end, the government announced a comprehensive departmental review of the CRA's service model that will examine all aspects of the CRA's work. The government is proposing to spend $206 million over five years, starting in 2018 — 19, and $33.6 million per year on ongoing basis.

The government is proposing additional funding to enhance its telephone technology and to hire more agents while at the same time provide additional training to ensure that Canadians get the correct information when they contact the CRA.

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is Managing Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

Debbie.Pearl-Weinberg@cibc.com

Debbie Pearl-Weinberg, LLB is Executive Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

1 Adjusted aggregate investment income excludes taxable capital gains/losses from the disposition of property used principally in a Canadian active business and the disposition of shares of connected CCPC in certain circumstances, net capital losses carried forward, dividends from connected corporations, and investment income that is incidental to an active business (such as interest from short-term deposits held for operational purposes.) It includes dividends from non-connected corporations (e.g. public company dividends.)

2 A tax advisor should be consulted before investing in corporate owned life insurance. It should also be considered whether this fits into your overall financial plan.

3 The main advantages of an IPP are that you can potentially contribute more money than you could with an RRSP and the plan is creditor-protected to the extent provided under the governing pension benefits legislation. There are setup and ongoing administrative costs associated with an IPP.

4 A tax advisor should be consulted before setting up an IPP.

5 See, C.D. Howe Institute, "The Knowledge Deficit about Taxes: Who It Affects and What to Do About It," Antoine Genest-Grégoire, Luc Godbout & Jean-Herman Guay (July 2017), which is available online at https://www.cdhowe.org/public-policy-research/two-parent-families-children-how-effective-tax-rates-affect-work-decisions.

6 Certain trust that are excluded from this reporting requirement include: mutual fund trusts, segregated funds trusts, trusts governed by registered plans (e.g. RRSPs, TFSAs, RESPs, etc.), lawyers' general trust accounts, graduated rate estates and qualified disability trusts and trusts that qualify as non-profit organizations or registered charities.

7 2017 Fall Reports of the Auditor General of Canada to the Parliament of Canada, "Report 2—Call Centres—Canada Revenue Agency," which can be found online at: http://www.oag-bvg.gc.ca/internet/English/parl_oag_201711_02_e_42667.html.