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Tax Alert — Canada

Private company insights: federal budget 2018-19

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 27 February 2018, federal Finance Minister Bill Morneau tabled his third budget. The following is the executive summary highlights of Budget 2018 that are relevant to private companies and their shareholders.

For a comprehensive and detailed review of all Budget 2018 measures, please read our Tax Alert on the 2018-19 federal budget.

Private company tax planning

On 18 July 2017, the federal government proposed to increase the tax rate on passive earnings derived from the reinvestment of after-tax corporate business earnings in passive investments. These proposals, if enacted, could have resulted in effective tax rates on passive earnings in excess of 70%.

In October 2017, the government announced that proposals targeting the reinvestment of after-tax corporate business earnings in passive investments would be limited to private corporations with passive investment income in excess of $50,000. The government further announced that draft legislation for these proposals would be released in Budget 2018.

For more on the background to these proposals, see our 2017 Tax Alerts No. 33, No. 48 and No. 52.

As outlined below, the July 2017 proposals and October 2017 clarifications will not proceed as previously announced, and the resulting proposed approach to passive income taxation will be reduced in scope and simplified. The proposed measures take into account feedback received during the consultation period associated with the July 2017 proposals.

Building a better working world

Budget 2018 proposes two modest measures to limit certain tax advantages of private companies earning passive investment income. These measures are generally applicable for taxation years beginning after 2018.

Small business deduction

Under existing legislation, the small business deduction is available on active business earnings of up to $500,000. No changes were announced relating to the scheduled reduction of the federal small business tax rate to 9% as of 2019. The availability of the small business deduction must be shared by companies that are part of an associated group. Existing legislation reduces the available small business deduction to the extent an associated group of companies has taxable capital in excess of $10 million.

To ensure the small business deduction is used by companies to reinvest in their active business, and not in passive assets, Budget 2018 proposes a further reduction to the $500,000 small business limit for Canadian Controlled Private Corporations (CCPCs) that have passive investment income in excess of $50,000. The new reduction is complimentary to the taxable capital reduction of the small business limit. The entire small business deduction would be unavailable if income from passive investments of the associated group exceeds $150,000, or if the taxable capital exceeds $15 million; where a CCPC meets one or both conditions, the greater reduction amount will be applied.

In general terms, the passive income-based reduction to the small business limit will apply to investment income with some adjustments:

- Taxable capital gains (and losses) realized on property that is used in an active business in Canada will be excluded.
- Taxable capital gains (and losses) realized on shares of another connected CCPC, where the other CCPC's assets are all or substantially all used principally in an active business in Canada, will be excluded.
- Net capital losses carried over from other years will be excluded.
- Dividends from non-connected corporations will be added.
- Income from a non-exempt life insurance policy will be added to the extent it's not already part of aggregate investment income.

The new reduction will be tested annually and based on income from the prior year. It is conceivable that a corporation could regain access to the small business deduction if the investment income falls below the threshold.

Additionally, a new deeming rule has been proposed that could associate two related (but not otherwise associated) companies for the purposes of the small business limit, if one company lends or transfers property, directly or indirectly, to the other with a view to reduce the amount of the small business limit reduction.

The new reduction will be applicable to taxation years that begin after 2018. A proposed anti-avoidance rule would make the rules applicable earlier, should a corporation have a short tax year in an attempt to defer the application of the new rules.

Changes to refundable dividend tax on hand

CCPCs' passive investment income is generally "integrated," meaning that investment income is corporately taxed at approximately the same rate as an individual at the top marginal tax rate. To preclude double taxation, a portion of the CCPC's corporate tax is refunded on the payment of dividends to individual shareholders and the refund is designed to approximate the personal tax payable by the shareholder. The refundable portion of the tax is tracked in the corporate refundable dividend tax on hand (RTDOH) account.

The July 2017 proposals included a discussion that could have eliminated the refundable portion of a CCPC's tax on investment income. Budget 2018 will not proceed with the July 2017 proposals.

Budget 2018 proposes a modified system for dealing with the recovery of RDTOH. The new system will create eligible and non-eligible RDTOH accounts and is generally designed to attempt to limit the recovery of RDTOH on the payment of an eligible dividend funded from active business earnings. RDTOH applicable on dividends from Canadian public companies will generally continue to be recovered with eligible dividends.

Transitional rules will address existing RDTOH accounts. To the extent a CCPC has historically paid sufficient general rate corporate income tax, existing RDTOH may still be recovered through the payment of eligible dividends.

The new measures are effective for taxation years beginning after 2018. An anti-avoidance rule will apply to prevent the deferral of the application of this new system through the creation of a short taxation year.

Income sprinking

The government confirmed intentions to proceed with the income tax measures released on 13 December 2017 to address income sprinkling. These measures generally became applicable on 1 January 2018.

No proposals on capital gains and dividend taxation

In July 2017, the government introduced draft legislation relating to the multiplication of the lifetime capital gains exemption, as well as the conversion of income into capital gains. In October 2017, the government announced it would not be proceeding with such draft proposals. There was no further mention of these or similar proposals in Budget 2018. Furthermore, the capital gains inclusion rate remains at 50%.

Corporate tax rates

No further changes are proposed to the general, small-business or passive rates of corporate income tax. Previously announced proposals to reduce the small business rate to 9% were reconfirmed.

See Appendix A for a complete listing of corporate income tax rates.

Other corporate measures

Budget 2018 also proposes the following measures:

- Currently there are administrative positions regarding Health and Welfare Trusts. In 2010, specific rules were introduced into the *Income Tax Act* (the Act) relating to Employee Life and Health Trusts. Budget 2018 announced that the CRA will no longer apply its administrative positions with respect to Health and Welfare Trusts after the end of 2020. To facilitate the conversion of Health and Welfare Trusts to Employee Life and Health Trusts traditional rules will be added to the Act following a consultation period.

- Budget 2018 proposes to clarify that the at-risk rules apply to a partnership that is itself a limited partner of another partnership.

- Budget 2018 proposes to extend the period for eligible additions to an accelerated capital cost allowance for specified clean energy generation and conservation equipment by five years to the end of 2024.

- Budget 2018 proposes certain measures regarding cross border tax structures to deal with perceived abuses by using partnership and pooling of employees and assets across multiple businesses. Further details are provided in EY's comprehensive federal budget Tax Alert.

- Budget 2018 proposes to advance the deadline for filing form T1134 for Foreign Affiliates to align with the corporations tax filing deadline of six months after the year-end. The accelerated filing will be applicable for tax years that begin after 2019.

- The Department of Finance indicated it will conduct a detailed analysis of the US federal tax reforms to assess potential impacts on Canada. Further details will be announced as they become available.

Personal income tax measures

Personal income tax rates

Budget 2018 did not propose changes to individual income tax rates or tax brackets. The brackets will continue to be indexed for inflation. See Appendix B for the highest combined marginal income tax rates by province and territory.

Other personal measures

Budget 2018 includes the following tax credit and other personal tax proposals:

- **Canada workers benefit:** For 2019, the amount of the benefit will be increased to a maximum benefit of $1,355 for single individuals and $2,335 for families. The benefit is income tested and is phased out entirely with family income in excess of $36,483.

- **Medical expense tax credit:** Budget 2018 proposes to allow as medical expenses such expenses where they are incurred in respect of an animal specially trained to perform task for a patient with a severe mental impairment.

- **Mineral exploration:** The mineral exploration tax credit on specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors will be extended to flow-through share agreements entered into on or before 31 March 2019. The credit was scheduled to expire on 31 March 2018.

Reporting requirements for trusts

Budget 2018 proposes to require that certain trusts provide additional information on an annual basis. Information such as the identity of all trustees, beneficiaries and settlors will be required to be filed for 2021 and subsequent taxation years. Failure to provide the information will result in the application of penalties.

Webcast

5 March webcast: Join us for a candid discussion of how the budget measures might impact Canadian private companies. The session will be hosted by EY Tax Partners Gabriel Baron and Ryan Ball. Please confirm your attendance by 4 March by **completing the online registration form.**

Learn more

For more information, please contact your EY or EY Law advisor.

And for up-to-date information on the federal, provincial and territorial budgets, visit ey.com/ca/budget.

Appendix A

2018 combined corporate income tax rates (as at 27 February 2018)

	Corporate income tax rates for active business income			Corporate investment income tax rates	
	Income eligible for small business deduction (SBD) (%) (generally up to $500,000)	Manufacturing and processing (M&P) income not eligible for federal SBD (%) (greater than $500,000)	General income not eligible for SBD (%) (non-M&P income)	Investment income earned by CCPCs (%)	Investment income earned by non-CCPCs (%)
	%	%	%	%	%
Federal only	10.00	15.00	15.00	38.67	15.00
British Columbia	12.00	27.00	27.00	50.67	27.00
Alberta	12.00	27.00	27.00	50.67	27.00
Saskatchewan	12.00 (up to $500K) 17.00 ($500K-$600K)	25.00	27.00	50.67	27.00
Manitoba	10.00 (up to $450K) 22.00 ($450K-$500K)	27.00	27.00	50.67	27.00
Ontario	13.50	25.00	26.50	50.17	26.50
Quebec	18.00/14.00	26.70	26.70	50.37	26.70
New Brunswick	12.62	29.00	29.00	52.67	29.00
Nova Scotia	13.00	31.00	31.00	54.67	31.00
Prince Edward Island	14.50	31.00	31.00	54.67	31.00
Newfoundland and Labrador	13.00	30.00	30.00	53.67	30.00
Northwest Territories	14.00	26.50	26.50	50.17	26.50
Nunavut	14.00	27.00	27.00	50.67	27.00
Yukon	11.50/12.00	17.50	27.00	50.67	27.00

*Rates presented above are prorated, where applicable, on a calendar-year basis.

Appendix B

Maximum combined personal marginal income tax rates (as at 27 February 2018)

	2017	2018	2018 Eligible dividends	2018 Ordinary dividends	2018 Capital gains
	%	%	%	%	%
Federal only	33.00	33.00	24.81	26.64	16.50
British Columbia	47.70	49.80	34.20	43.73	24.90
Alberta	48.00	48.00	31.71	41.64	24.00
Saskatchewan	47.75	47.50	29.64	39.76	23.75
Manitoba	50.40	50.40	37.78	45.92	25.20
Ontario	53.53	53.53	39.34	46.84	26.76
Quebec	53.31	53.31	39.83	43.94	26.65
New Brunswick	53.30	53.30	33.51	46.88	26.65
Nova Scotia	54.00	54.00	41.58	47.33	27.00
Prince Edward Island	51.37	51.37	34.22	44.26	25.69
Newfoundland and Labrador	51.30	51.30	42.61	43.81	25.65
NorthwestTerritories	47.05	47.05	28.33	35.98	23.53
Nunavut	44.50	44.50	33.08	36.78	22.25
Yukon	48.00	48.00	28.92	41.42	24.00

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