Budget 2018 – Equality + Growth: A Strong Middle Class

The government may have brought out many of their plans late last year and left nothing for their Budget. The 2018 Federal Budget, introduced on Feb. 27, 2018 by Minister of Finance, Bill Morneau, appears to be relatively light. Rules governing passive investment income earned by corporations have been clarified, but very little else.

The main theme for 2018 is to make adjustments in personal tax rates and in equal pay to create “a fair tax system for all Canadians”. Specific to wealth management and insurance, the most significant proposals relate to holding passive investments within a private corporation and to help place limits on international tax evasion. Closing loopholes “that result in unfair tax advantages for some at the expense of others” and assisting with investigation and prosecution of tax evaders appears to be another priority.

Post-Budget planning strategies should focus on eliminating or reducing passive income and/or incur expenses to offset passive income in corporate structures. This planning could include using corporate class funds, exempt life insurance policies, annuities and critical illness insurance policies. Strategies may also include individual pension plans (IPPs) and business-owner leveraging.

As Minister Morneau explains: “To have an economy that works for everyone, we need a tax system that is fair, and we need all Canadians to pay their fair share. Delivering the programs and services that Canadians need, while keeping taxes low for small businesses and middle class families, is important to this Government, and to all Canadians.”

Holding passive investments inside a private corporation

In October 2017, the Government proposed to lower the tax rate for small businesses from 10.5 per cent to 9.0 per cent by 2019, which is intended to increase the after-tax income available for reinvestment into active businesses.

Corporate business income is taxed at lower rates than personal income to provide businesses with more money to invest, to grow and to create jobs. Currently, however, some corporate owners can gain a significant tax deferral by saving corporate after-tax income inside their corporation instead of paying it out to them personally. The government decided action was needed to ensure the tax system encourages corporate owners to use low corporate tax rates to support their business, not for achieving a tax deferral.

Budget 2018 proposes two measures, applicable to taxation years that begin after 2018, to limit tax deferral advantages achieved by saving business income earned inside private corporations. These two measures affect 1) a corporation’s access to the small business tax rate where it’s passive income exceeds $50,000 and 2) a corporation’s ability to receive a refund of refundable taxes upon the payment of an eligible dividend.

Limiting access to the small business deduction limit:

A Canadian Controlled Private Corporation’s (CCPC) small business limit entails that its first $500,000 of active business income is taxed at a very low rate - around 12% in many provinces. This limit decreases for

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corporations with taxable capital over $10M and is eliminated when that amount reaches $15M. As an additional limit on the small business deduction, the budget proposes to reduce the small business limit for CCPCs that have income from passive assets in excess of $50,000. This new measure would reduce a CCPC's small business limit to nil on a straight-line basis when it earns investment income between $50K and $150K.

Such an approach could reinforce the principle that the small business rate is designed to target and support only small businesses. Under the proposal, if a corporation earns more than $50,000 of passive investment income in a given year, the amount eligible for the small business tax rate would be gradually reduced. Finance proposes the small business deduction limit be reduced by $5 for $1 of investment income above the $50,000 threshold (equivalent to $1 million in passive investment assets at a five-per-cent return), such that the business limit would be reduced to zero at $150,000 of investment income (equivalent to $3 million in passive investment assets at a five-per-cent return). The approach is much simpler to comply with in comparison to the original proposals affecting corporate passive investment income which eliminated refundable taxes on passive income in excess of $50,000 per year.

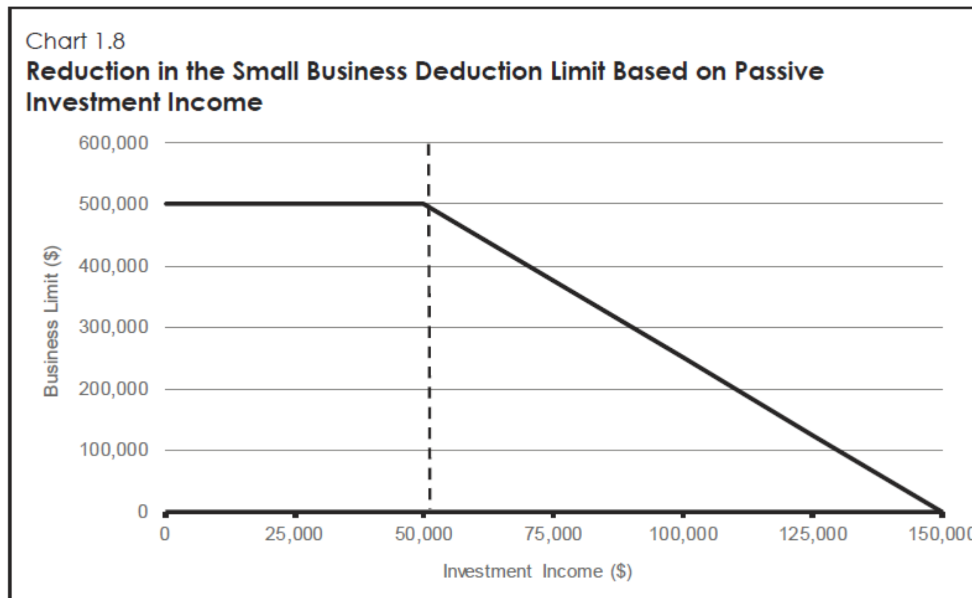

Chart 1.8
Reduction in the Small Business Deduction Limit Based on Passive Investment Income

Source: *Equality + Growth: A Strong Middle Class*, Department of Finance, Feb. 27, 2018.

Active business income qualifying for the small business tax rate under new business limit ($)

Business Income	Investment Income				
	50,000	75,000	100,000	125,000	150,000
50,000					0
75,000	NOT AFFECTED				0
100,000					0
200,000				125,000	0
300,000			250,000	125,000	0
400,000		375,000	250,000	125,000	0
500,000		375,000	250,000	125,000	0

Note: Assumes that the corporation has less than $10 million of taxable capital.

Source: *Equality + Growth: A Strong Middle Class*, Department of Finance, Feb. 27, 2018.

Adjusted aggregate investment income:

For purposes of calculating the business limit reduction, the Budget proposes a new concept to measure investment income based on the existing meaning of “aggregate investment income” in the Income Tax Act (Canada) with certain adjustments:

- Taxable capital gains (and losses) will be excluded to the extent they arise from the disposition of a property that is used principally in an active business.
- Net capital losses carried over from other taxation years will be excluded.
- Dividends from non-connected corporations will be added.
- Income from savings in a non-exempt life insurance policy will be added.

It’s worth noting that the passive investment rules don’t apply to exempt life insurance policies, unless there’s a disposition resulting in a policy gain. Taxable portions from annuity payments and allocations from segregated funds would be caught by the proposed passive income rules.

Limiting access to refundable taxes

If a client’s company earns income in excess of the small business limit, they could obtain a tax advantage by paying an eligible dividend, which are taxed at lower rates, to obtain a refund of refundable taxes previously paid on investment income [referred to as refundable dividend tax on-hand (RDTOH)]. Budget 2018 generally proposes that CCPCs no longer be able to obtain RDTOH refunds as a consequence of paying eligible dividends (generally dividends from income taxed at the general corporate rate). It proposes that a refund of RDTOH be available only where a private corporation pays non-eligible dividends. There is an exception allowing for RDTOH refunds arising from the payment of eligible dividends where the refundable taxes (Part IV tax) are paid as a result of receiving an, eligible portfolio dividend.

Affected clients will require a new RDTOH account.

- This new account (eligible RDTOH) will track refundable taxes paid under Part IV of the *Income Tax Act* on eligible portfolio dividends. Any taxable dividend (i.e., eligible or non-eligible) will entitle the corporation to a refund from its eligible RDTOH account (subject to the new ordering rule).
- The current RDTOH account (which will now be referred to as non-eligible RDTOH) will track refundable taxes paid under Part I of the *Income Tax Act* on investment income as well as under Part IV on non-eligible portfolio dividends (i.e., dividends that are paid by non-connected corporations as non-eligible dividends). Refunds from this account will be obtained only upon the payment of non-eligible dividends.

There is also a new ordering rule that directs how to obtain RDTOH refunds. Upon the payment of a non-eligible dividend, a private corporation will be required to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

Corporations currently set up as holding or investment companies that do not earn active business income should be minimally affected by these new rules.

“Income sprinkling” using private corporations

“Income sprinkling” rules using private corporations introduced December 2017 are not specifically addressed but totals are included in the cost reduction the government expects to materialize over the next five years. It therefore appears the rules remain unchanged from their introduction.

Other Budget 2018 highlights:

- **Previously announced measures** – Budget 2018 confirms the Government's intention to proceed with Information-reporting requirements for certain dispositions of an interest in a life insurance policy.
- **Registered Disability Savings Plan (RDSP)** – A qualifying family member (i.e., a parent, spouse or common-law partner) can be the plan holder for the individual's RDSP (temporary federal measure). The measure in place was set to expire at the end of 2018, but is proposed to be extended for another five years.
- **Reporting requirements for trusts** – Budget 2018 proposes to require more comprehensive reporting by trusts, with certain exceptions including mutual fund trusts, segregated funds master trusts and graduated rate estates.
- **Deductibility of Quebec Pension Plan (QPP) contributions** – Budget 2018 proposes allowing a deduction for employee contributions to the enhanced portion of the QPP (to provide consistent income tax treatment between it and CPP).
- **Health and welfare trusts** – Currently CRA will no longer apply their administrative positions after 2020 so the Employee Life and Health Trust rules added in 2010 will be the only rules in effect after that date. A consultation period is open for comments until June 29, 2018.
- **Reporting requirements for trusts** – Mutual fund trusts, segregated funds and master trusts are exempt from reporting requirement changes where trusts will need to file T3 returns where one does not currently exist.
- **Tax evasion and combating tax avoidance** – Canada Revenue Agency (CRA) will start sharing tax-related information with the Attorney General and the Department of Justice to help combat tax evasion. As well, information relating to the *Excise Tax Act* may be disclosed to police officers to help further their investigations.
- **Canada workers benefit** – Formerly known as the Working income tax benefit, it has been renamed with increased benefit for Canadian individuals earning less than $24,111 and families earning up to $36,483; applies to 2019 and subsequent taxation years.

APPENDIX:

Examples of how these changes may affect businesses that hold passive investments

Elise owns a catering business. Her corporation earns $100,000 (after tax) in business income each year, and pays out $75,000 as dividends to cover Elise's living expenses. She saves the other $25,000 in each of the next three years to build up a fund for her planned parental leave. Elise will not be affected by the new rules because the investment income on her savings will be well below the $50,000 threshold, and she does not earn business income taxed at the general corporate rate.

Simon is an incorporated farmer. Whenever possible, he puts aside excess income 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 passive income. As such, Simon will not be affected by the new rules.

Claire launched a successful retail business and now uses the retained earnings in her corporation to invest in promising start-ups. She sold her 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 will not be affected by the new rules because her ownership stake in this active business is such that her capital gain will not count towards the $50,000 threshold, and she is actively reinvesting.

Amrita owns a hotel. Her 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 she does not earn business income taxed at the general corporate rate.

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.

Louis owns a very profitable private corporation that 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, Louis will no longer receive the benefit of the small business rate to fund further passive investments, starting in 2019. All of his business' income will be taxed at the general corporate rate.

Source: *Equality + Growth: A Strong Middle Class*, Department of Finance, Feb. 27, 2018.