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TAXATION · ACCOUNTING · ASSURANCE

2018 FEDERAL BUDGET SUMMARY

Finance Minister Bill Morneau released the 2018 Federal Budget (the "Budget") on February 27, 2018 ("Budget Day"). The most anticipated changes related to the passive investment proposals, which were summarized in our last release. What follows is a more detailed analysis of the most significant changes proposed in the Budget.

PERSONAL INCOME TAX MEASURES

Canada Workers Benefit

The Working Income Tax Benefit will be renamed to the Canada Workers Benefit and will be enhanced beginning in 2019. The enhanced benefit will be equal to 26% of earned income in excess of $3,000 to a maximum of $1,355 for single individuals without dependants and $2,335 for families. The benefit will be reduced by 12 per cent of adjusted net income in excess of $12,820 for single individuals without dependants and $17,025 for families.

For disabled individuals, the Canada Workers Benefit 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. 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.

Enhanced QPP Contributions

Consistent with the available deduction from income for contributions relating to the enhanced portion of the Canada Pension Plan (CPP) starting in 2019, a deduction will also be allowed for contributions relating to the enhanced portion of the Quebec Pension Plan (QPP) starting in 2019.

Mineral Exploration Tax Credit

Eligibility for the credit will be extended for one additional year to include flow-through share agreements entered into on or before March 31, 2019.

Reporting Requirements forTrusts

New reporting requirements will be introduced in respect of express trusts resident in Canada and non-resident trusts currently required to file a T3 return, effective for 2021 and subsequent taxation years. The following trusts will be excluded:

- mutual fund trusts, segregated funds and master trusts;
- trusts governed by registered plans (i.e., deferred profit sharing plans, pooled registered pension plans, registered disability savings plans, registered education savings plans, registered pension plans, registered retirement income funds, registered retirement savings plans, registered supplementary unemployment benefit plans and tax-free savings accounts);
- 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 these new reporting rules do apply to a trust, it will be required to file a T3 return for the year and report the identity of the following persons:

- all trustees;
- all beneficiaries;
- all settlors; and
- any 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).

Failure to comply with these reporting requirements will result in the application of penalties in the amount of $25 per day that the filing is late, with a minimum penalty of $100 and a maximum penalty of $2,500. If a failure to file the return was made knowingly, or due to gross negligence, an additional penalty will apply. The additional penalty will be equal to 5% of the maximum fair market value of property held during the relevant year by the trust, with a minimum penalty of $2,500. As well, existing penalties will continue to apply.

BUSINESS INCOME TAX MEASURES

Passive Investment Income

These changes, which are effective for taxation years that begin after 2018, were discussed in our previous release but will be repeated here with some additional level of detail.

There will be a new grind on the $500,000 annual business limit which is the maximum amount of the aggregate active business income (ABI) of a Canadian-controlled private corporation (CCPC) and its associated CCPCs that can be taxed at the small business tax rate (12% in BC in 2018). This new grind will be based upon the passive investment income of the associated group of corporations in the prior year and will reduce the business limit by $5 for every $1 that the aggregate passive investment income of the prior year exceeds $50,000. Hence, the business limit will be eliminated once that aggregate passive investment income of the prior year has reached $150,000. Any income not eligible for the small business tax rate as a result of the grind will be taxed at the general tax rate (27% in BC in 2018). This represents a reduction in the tax deferral available by earning ABI through a CCPC.

For purposes of the grind on the business limit, certain types of income will be added or excluded from the aggregate passive investment income of the associated group of companies as follows:

- taxable capital gains (and losses) will be excluded to the extent they arise from the disposition of:
- net capital losses carried over from other taxation years will be excluded;
- dividends from non-connected corporations will be added; and
- income from savings in a life insurance policy that is not an exempt policy will be added, to the extent it is not otherwise included in aggregate investment income.

A portion of the taxes paid by private corporations on passive investment income ("RDTOH") is currently refundable when the corporation pays taxable dividends to its shareholders. Under current rules, it does not matter whether or not those dividends are considered to be eligible or non-eligible for income tax purposes. Eligible dividends are paid out of the general rate income pool (GRIP) which represents the after-tax ABI of the corporation that was subjected to the general tax rate (as discussed above). Eligible dividends are generally taxed at a lower rate than non-eligible dividends when they are received by an individual. The Budget proposes to deny the refund where eligible dividends are paid by a private corporation. A dividend refund will therefore only be available when non-eligible dividends are paid. This will potentially increase the taxes paid by an individual who receives the dividend. However, the GRIP available for payment of an eligible dividend will still be available so that tax advantage may simply be deferred until a future year when an eligible dividend is paid.

An exception will be provided where the corporation receives eligible portfolio dividends (e.g. from public companies) and is required to pay Part IV taxes on the dividend. Those taxes will be added to the eligible RDTOH pool.

Any RDTOH that remains at the end of the corporation's last taxation year before the new rules take effect (after taking into account the dividend refund for that year) will be divided up into the two separate pools – eligible RDTOH and non-eligible RDTOH. Eligible RDTOH will be able to be refunded to the corporation when eligible dividends are paid by the corporation. The amount added to eligible RDTOH will be the lesser of:

1. The closing RDTOH balance for the pre-transition year less any dividend received in the year; and
2. 38 1/3% of the closing GRIP balance for the pre-transition year less any eligible dividends paid in the year.

This will ensure that, after transition, any RDTOH remaining from prior to transition can refunded through payment of eligible dividends arising out of GRIP that remained prior to transition. Any RDTOH which does not fall within the above limit on transition will be added to non-eligible RDTOH and will only be able to be refunded where the corporation pays non-eligible dividends.

Any RDTOH which flows through connected corporations as a result of dividend payments will retain its status as eligible or non-eligible as it flows through. There will also be an ordering rule requiring that the non-eligible RDTOH pool be reduced first when a non-eligible dividend is paid, followed by the eligible RDTOH pool. Finally, an anti-avoidance rule will be introduced to ensure that taxpayers do not trigger a short taxation year in order to maximize the access to the current rules before transition.

At-risk Rules for Tiered Partnerships

The at-risk rules will be amended to clarify that the at-risk rules apply to a partnership that is a limited partner of another partnership, which will limit the amount of limited partnership losses that can be flowed through to the ultimate members of the partnership group. Furthermore, losses allocated to a limited partner that is itself a partnership will no longer be eligible to be carried forward to be applied against income in future years.

These rules are effective for taxation years that end on or after Budget Day. The rules will also apply to ensure that losses incurred in prior years cannot be carried forward to be applied against income in any taxation year that ends after Budget Day.

Health and Welfare Trusts

After 2020, CRA will no longer apply their administrative positions with respect to the taxation of a Health and Welfare Trust (HWT). Existing HWTs will be able to convert to an Employee Life and Health Trust (ELHT), which is a defined plan within the Income Tax Act, and transitional rules will be provided to facilitate this conversion. HWTs that do not convert before 2021 will become subject to the general rules for taxation of trusts and will not be entitled to the benefit of any prior CRA administrative policies benefitting HWTs. Finance has asked for stakeholders to provide comments on transitional issues any time up to June 29, 2018 and will not release draft legislative proposals until after that consultation period has been completed.

INTERNATIONAL TAX MEASURES

Cross-border Surplus Stripping Using Partnerships and Trusts

New "look through" rules will prevent taxpayers from using certain structures that include partnerships and trusts from circumventing the non-resident anti-surplus stripping rules. These rules will apply to transactions that occur on or after Budget Day.

Foreign Affiliates

The ownership of a foreign affiliate (FA) may require that the Canadian owners include in their income their proportionate share of certain kinds of income earned by the FA, known as foreign accrual property income (FAPI). Generally, FAPI consists of income which is passive in nature and generally excludes active business income (subject to certain modifications). The Budget proposes new rules which will prevent taxpayers from using certain income streaming arrangements combined with broadly held ownership structures in order to avoid the application of the FAPI rules. These new rules will apply to taxation years of the foreign affiliate that begin after Budget Day.

The normal reassessment period for a taxpayer in respect of income arising in connection with a foreign affiliate owned by the taxpayer will be extended by three additional years. This new rule will apply to taxation years that begin on or after Budget Day.

The filing deadline for information returns relating to the ownership of foreign affiliates during the year will be reduced from 15 months after the end of the taxation year of the taxpayer to 6 months after the end of that year. This will mean that taxpayers must gather the necessary information for their foreign affiliates and report 9 months sooner than has been required in the past. This may be a significant burden that will now need to be met. This change will apply to taxation years that begin after 2019.

Normal Reassessment Period for Requirements for Information and Compliance Orders

The Budget proposes to extend the normal reassessment period for a taxation by the amount of time during which a requirement for information (from CRA) or a compliance order (from a Court) is being challenged in court. This new "stop the clock" rule will apply to any court challenge raised on or after the legislation receives Royal Assent.

Normal Reassessment Period for Loss Carrybacks

Where a taxpayer has engaged in transactions with non-arm's length non-residents during a year (the "base year"), the normal reassessment period for that year is extended by 3 additional years for purposes of those transactions only. The Budget proposes to also extend the normal reassessment period of any year to which a loss may have been carried back from the base year, but only to the extent that the loss carryback was reduced because of an adjustment to those relevant transactions. This new rule will apply to any taxation year to which a loss has been carried back from a taxation year that ends on or after Budget Day.

SALES AND EXCISE TAX MEASURES

Cannabis Taxation

A new federal excise tax regime has been proposed for cannabis and related products approved for legal purchase, such as:

- fresh and dried cannabis;
- cannabis oils; and
- seeds and seedlings for home cultivation.

Cannabis cultivators and manufacturers will be required to obtain a cannabis licence from the CRA and remit the excise duty, where applicable. The framework will come into effect when cannabis for non-medical purposes becomes available for legal retail sale.

Excise duties will be imposed on federally-licenced producers ("cannabis licensees") at the higher of a flat rate applied on the quantity of cannabis contained in a final product and a percentage of the dutiable amount of the product as sold by the producer. The dutiable amount generally represents the portion of the producer's sales

sales price that does not include the cannabis duties under the Excise Act, 2001. The proposed excise duty framework will be applied as follows:

- A flat rate duty will be imposed, at the time of packaging for final retail sale, on the quantity of cannabis flowering and non-flowering material (generally referred to as "flower" and "trim," respectively), as well as on cannabis seeds and seedlings (e.g., in the case of home cultivation).
    - The flat rate duty will be imposed on a dollar-per-gram basis, or dollar-per-seed/seedling basis in the case of seeds/seedlings.
    - A lower rate per gram will be applied for trim as compared to flower.
    - A product will generally be considered to be "packaged" by a cannabis licensee when it is put in a container intended for sale to a final consumer at the retail level.
- At the time of delivery of a cannabis product by the cannabis licensee that packaged it to a purchaser (e.g., a provincially-authorized distributor), an ad valorem rate will also be imposed on the dutiable amount of the transaction.
- Cannabis licensees selling to purchasers will be liable to pay duty at the higher of the flat rate or the ad valorem rate on the product. The applicable duty will only become payable at the time of delivery to a purchaser.
    - The cannabis licensee who packaged the cannabis product for final retail sale will be liable to pay the applicable excise duty.
- All cannabis products that will be removed from the premises of a cannabis licensee to enter into the Canadian market for retail sale will be required to have an excise stamp. Excise stamps will have specified colours indicating the provincial or territorial market in which it is intended to be sold. It will be the responsibility of the cannabis licensee who packaged the cannabis product to determine and apply the appropriate excise stamp before its entry into the duty-paid Canadian market.

Exemptions will be provided where a product has no more than 0.3% THC content. The GST rules will be amended to ensure that GST continues to apply to all products. These rules are intended to apply by the time cannabis for non-medical purposes becomes accessible for legal retail sale.

SUMMARY

While the changes were not as significant as rumored, there are some changes which may impact you. We encourage you to contact your Johnsen Archer advisor at any time to discuss the changes and their impact on you or your business.

Thank you for your business!