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Tax Alert — Canada

Federal budget 2018-19: Equality + Growth – A Strong Middle Class

"Mr. Speaker, …[this budget] is a plan that puts people first. That invests in Canadians and in the things that matter most to them. It's a plan that builds on the hard work of Canadians, and that keeps us squarely focused on the future.

"Today, Canada leads all the other Group of Seven (G7) countries in economic growth — and Canadians are feeling confident about the future. …That's why we are able to invest in the things that matter to Canadians, while making steady improvements to our bottom line."

Federal Finance Minister Bill Morneau
2018 federal budget speech

Tax policy and economic outlook

On 27 February 2018, federal Finance Minister Bill Morneau tabled his third budget. With a focus on economic growth, job creation and a strong middle class, the minister pledged to continue building Canada's economy by seeking to create an innovative, inclusive and sustainable economy, and by creating opportunities for the middle class — with the aim of addressing gender-based inequality.

In his budget speech, Morneau stated, "The Canadian economy is doing well — remarkably well. Over the last two years, hard-working Canadians have created nearly 600,000 new jobs, most of them full-time. Unemployment rates are near the lowest levels we've seen in over 40 years."

"Mr. Speaker, our plan is working because *Canadians* are working.

"We know there are challenges in the immediate term, and we are responding to those challenges. We know businesses are concerned about the outcome of North American Free Trade Agreement talks, and tax changes in the United States. We will be vigilant in making sure Canada remains the best place to invest, create jobs and do business — and we will do this in a responsible and careful way, letting evidence, and not emotion, guide our decisions. At the same time, we need to stay focused on our long-term goal of building an economy that works for everyone."

Surplus (deficit) and federal debt outlook

For a number of years, EY's federal budget Tax Alert has included projections of the federal surplus or deficit, the federal debt and a budgetary scorecard. The latest projections for fiscal 2017-18 and 2018-19 are slightly improved from those expected a year ago.

Budgetary scorecard

In very general terms, the annual surplus (deficit) is the amount by which the government's revenue from all sources exceeds or is less than the aggregate of program expenses (including transfers to other governments) and the public debt charge.

In Table A, we summarize the deficit projections for fiscal 2017-18 and fiscal 2018-19, including spring update to fiscal 2017-18 (the final fiscal 2017-18 accounts will be released in the fall 2018 economic update).

Fiscal 2017-18

The current update reflects an improved economic and fiscal outlook since Budget 2017. The Liberal government's projected fiscal deficit of $28.5 billion for 2017-18 has become a deficit of $19.4 billion. The change in the forecast is mainly attributed to the increase in corporate income tax revenue and a reduction in the risk assessment adjustment.

Table A

Projections of federal budgetary surplus (deficit) $billions

	Budget 2017	Spring 2018 Update	Budget 2018
	F2017-18	**F2017-18**	**F2018-19**
Revenue outlook			
Income taxes			
Personal	152.1	152.3	161.4
Corporate	43.6	48.2	47.3
Nonresident	6.9	8.2	8.3
Excise taxes			
GST	35.1	36.5	37.7
Customs	4.9	5.5	5.5
Other taxes/duties	11.7	11.6	12.1
EI premiums	21.2	20.6	21.7
Other revenues	29.1	26.8	29.4
	304.7	**309.6**	**323.4**
Program expenses outlook			
Major transfers to persons			
Elderly benefits	(51. 1)	(50.9)	(53.6)
EI benefits	(22.0)	(20.1)	(20.7)
Children's benefits	(23.0)	(23.4)	(23.7)
Major transfers to other levels of gov't	(70.2)	(70.5)	(73.6)
Direct program expenses	(139.1)	(139.7)	(140.5)
	(305.4)	**(304.6)**	**(312.2)**
Public debt charges	(24.7)	(24.4)	(26.3)
Assessment of risk	(3.0)		(3.0)
Surplus (deficit) outlook	**(28.5)**	**(19.4)**	**(18.1)**

Totals may not add due to rounding.

Fiscal 2018-19

The updated fiscal 2018-19 forecasted deficit is $18.1 billion, improved from the fall economic statement estimate of $18.6 billion.

Federal fiscal outlook

As set out in Table B, after accounting for economic and fiscal developments, the latest government projections call for a budgetary deficit in fiscal 2017-18, a reduced budget deficit in fiscal 2018-19 and in each subsequent year of the forecast period. Measured in relation to the size of the economy, the federal debt is expected to decline to 28.4% of gross domestic product (GDP) by 2022-23.

Canada's total government net debt-to-GDP ratio remains the lowest of any G7 country and among the lowest of the advanced G20 countries.

In October 2017, the International Monetary Fund estimated that Canada's total government net debt-to-GDP ratio is the lowest, by far, of any G7 country: Canada 24.6%, Germany 45.8%, US 82.5%, UK 80.5%, France 88.5%, Italy 121.2%, and Japan 120.9%.

Table B

Projections of federal surplus (deficit) and debt

	Surplus (deficit) outlook	Federal debt	
	$billion	$billion	% of GDP
2017-18	(19.4)	651.5	30.4
2018-19	(18.1)	669.6	30.1
2019-20	(17.5)	687.1	29.8
2020-21	(16.9)	704.0	29.4
2021-22	(13.8)	717.8	28.9
2022-23	(12.3)	730.1	28.4

Totals may not add due to rounding.

Government policy measures

Budget 2018 includes a number of measures to support economic growth by focusing on support for specific industries and research programs, providing additional support to small businesses and promoting high-skilled employment.

Some of the more significant measures include:

Women entrepreneurs

Budget 2018 announces $1.65 billion over three years in new financing for women entrepreneurs through the Business Development Bank of Canada and Export Development Canada.

The government announced it will provide $115 million over five years as part of a Women's Entrepreneurship Strategy that will comprehensively address barriers facing women entrepreneurs to starting and growing businesses, particularly in high-growth areas of the economy. This includes establishing a target that 15% of small to medium-sized enterprises (SMEs) supplying the Government of Canada are firms owned by women.

Innovation programs

Budget 2018 includes historic investment of nearly $4 billion over five years to support the next generation of Canadian researchers. Although much of this money is aimed at research institutions and academia, the government has renewed its promise to conduct historic reform of business innovation programs (through recently announced Innovation Canada) in order to further streamline business support programs along four new flagship "platforms" that will bring together multiple programs, including:

- The **Strategic Innovation Fund,** which will allow for more focused support for business research and development projects over $10 million and will move away from supporting smaller projects to support larger projects that can lead to significant job creation and shared prosperity for Canadians.
- The **Industrial Research Assistance Program,** which will support small-business research and development for projects up to a new threshold of $10 million (investment includes a further $700 million over five years to this program and $150 million ongoing).
- Renewed **regional development agencies,** which will encourage economic growth in communities across Canada (investment includes $511 million over five years. Of this amount, $105 million will support nationally coordinated and regionally tailored support for women entrepreneurs).
- The **Canadian Trade Commissioner Service,** which will help Canadian businesses access new opportunities and new customers around the world.

It is expected that the business innovation program review may result in streamlining of business innovation programs by up to two-thirds, although overall funding will increase.

The Government also plans to transform the National Research Council to reinforce its partnerships with Canada's top scientists and small and medium-sized enterprises (SMEs) committed to cutting-edge research and commercialization. The plan includes allocation of $540 million over five years, with $108 million ongoing to help reduce fees for participating businesses and advance high-potential research.

Intellectual property

Budget 2018 also promises a new, modern approach to intellectual property to help Canadian companies lead in the knowledge-based economy and allow Canadian innovators to better compete and access global markets. Details of the strategy will be announced by the Minister of Innovation, Science and Economic Development in the coming months.

Tax planning using private companies

Passive investment income

On 18 July 2017, the federal government proposed to tax the reinvestment of after-tax corporate business earnings in passive investments in private corporations on a go-forward basis. In mid-October 2017 (after the consultation period for the proposals ended on 2

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.

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

Budget 2018 proposes two measures to limit the deferral advantage of private companies earning passive investment income. These measures are applicable for taxation years beginning after 2018. Clearly the department of finance has reviewed the feedback received from the tax community and has proposed legislation that is much simpler and workable than what was discussed in the 18 July 2017 discussion document and the modifications mentioned in October 2017.

Small business deduction

Under existing legislation, the small business deduction is available on active business earnings of up to $500,000. The Government recently announced the reduction of the federal tax rate on income eligible for the small-business deduction to 9% as of 2019. The availability of the reduced rate must be shared by companies that are part of an associated group. Existing legislation reduces the income available for the small business deduction to the extent that an associated group of companies has taxable capital in excess of $10 Million.

As part of the commitment to ensure the small business deduction is used by companies to reinvest in their active business, and not in investment assets, a further grind to the $500,000 limit is introduced for Canadian-controlled private companies (CCPCs) that have income from passive investments in excess of $50,000. The new grind is included as part of the same provision that currently reduces the ability for CCPCs with more than $10 million of taxable capital. 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. Finance has estimated that about 3% of CCPCs claiming the small business deduction will be affected by the measure.

For the purposes of the income from passive investments calculation, new definitions will be added to the legislation to establish what is defined as "adjusted aggregate investment income." In general terms, the grind to the small business deduction will apply to income otherwise subject to refundable tax 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.

Some other comments on the new grind to the available small business deduction are as follows:

- The test is an annual test based on income for the year that ended in the preceding calendar year. Therefore it is conceivable that a corporation could regain access to the small business deduction if the investment income was high in one year and lower in following year.
- The grind is applicable to taxation years that begin after 2018. However, there will be an anti-avoidance provision to make the rules applicable earlier should a corporation have a short year end in an attempt to defer the application of the new rules.
- There is a deeming rule that could deem two related companies to be associated for the purposes of the small business deduction grind if one company lends or transfers property, directly or indirectly, to the other with a view to reduce the amount of the small business deduction grind.

Changes to refundable dividend tax on hand

The *Income Tax Act* (the Act) includes a longstanding system of integration for the earning and distribution of investment income by a private corporation.

This system provides for the investment income to be taxed at approximately the same rate that would apply if that income were earned by an individual at the top marginal tax rate. A portion of that tax is then refunded on the payment of dividends by the corporation to individual shareholders that are taxed personally. The refundable portion of the tax is tracked in the refundable dividend tax on hand (RDTOH) account.

The amount refunded to the corporation from RDTOH is designed to approximate the personal tax payable by the shareholder at the highest marginal tax rate. In effect, the system is designed so that the total tax paid by the corporation and the individual is approximately equal to the tax that would have been paid by the shareholder if they had personally earned the investment income.

The 18 July 2017 proposals included a discussion that would have eliminated this system of integration and would have subjected the fully distributed income earned through a private company to a far greater tax rate than would have been payable by the individual who would have otherwise earned that income. This proposal received a very negative response from the business owner and tax communities.

Currently, if the corporation has a balance in the General Rate Income Pool (GRIP) arising from income earned from a business (that was not eligible for the lower small business tax rate), they may designate the dividend paid to the shareholders, to recover RDTOH, to be an eligible dividend from its GRIP account. In these circumstances the individual is subject to personal tax at a lower tax rate than if it had not been designated as an eligible dividend. In these circumstances the total tax payable by the corporation and its individual shareholders on its investment income may be substantially lower than if the same income had been earned by the individual directly. This advantage varies greatly depending on the individual shareholder's province or territory of residence, as there are substantial differences between the eligible and non-eligible dividend rates in different jurisdictions. The differences range from 1% to about 15%. Most provinces are in the 6% to 10% range.

As a far more practical approach to dealing with concerns surrounding the advantages of earning passive income within private corporations, Budget 2018 proposes a modified system for dealing with the recovery of RDTOH and the payment of eligible dividends. The new system will create eligible and non-eligible RDTOH accounts. The system will allow a refund of the eligible RDTOH account on payment of an eligible dividend and a refund of the non-eligible RDTOH account on a non-eligible dividend. If the non-eligible RDTOH pool is fully exhausted, the eligible RDTOH account can be refunded on the payment of a non-eligible dividend. Eligible dividends can still be paid while the corporation has a non-eligible RDTOH pool, but they will effectively only track the active business income earned and not the investment income that actually generated the RDTOH balance, and would not provide a RDTOH refund. The eligible RDTOH pool will include dividends earned on portfolio dividends that were subject to refundable Part IV tax.

Transitional rules will apply to permit the RDTOH refunds on eligible dividends to the extent of GRIP balances arising in taxation years that commence before 2019. For Canadian Controlled Private Corporations ("CCPCs") the lesser of its existing RDTOH balance and 38 1/3 percent of its GRIP balance will be allocated to its eligible RDTOH account. Any remaining balance will be allocated to its non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

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.

Business income tax measures

Corporate tax rates

No new changes are proposed to the corporate income tax rates or to the $500,000 small-business income limit of a Canadian-controlled private corporation (CCPC). However, the budget re-confirms the reductions in the small-business corporate income tax rates previously announced in October 2017.

The enacted (or announced) Canadian federal corporate income tax rates are summarized in Table C.

Table C

Federal corporate income tax rates			
	2017	**2018**	**2019**
General corporate rate	15.0%	15.0%	15.0%
Small-business rate	10.5%	10.0% (Announced)	9.0% (Announced)

Accelerated capital cost allowance

Continuing with the theme of prior budgets, the minister announced changes impacting capital cost allowance rates:

- **Extension of availability of Class 43.2 –** Eligible investments in specified clean energy generation and conservation equipment may qualify for accelerated capital cost allowance rates by being included in either Class 43.1 or 43.2 (30% and 50% declining balance, respectively). Class 43.2 applies to eligible property acquired before 2020. It generally includes property that would otherwise be included in Class 43.1, except that in certain cases Class 43.2 imposes stricter eligibility criteria. Budget 2018 proposes to extend the availability of Class 43.2 by five years so that it will be available for eligible property acquired before 2025.

At-risk rules for tiered partnerships

Under existing legislation, limited partners of a partnership may deduct their share of the partnership's losses only to the extent of their at-risk amount. The at-risk amount of a limited partner generally represents the partner's invested capital that is at risk in the partnership. It consists of the adjusted cost base of the limited partner's interest in the partnership, subject to a number of adjustments (e.g., increased by partnership income allocated to the partner for the year, and decreased by amounts owed to the partnership).

The portion of the loss that exceeds the limited partner's at-risk amount is not deductible, but instead becomes a limited partnership loss, which may be carried forward indefinitely and deducted in a subsequent year to the extent that the limited partner's at-risk amount has increased. Any undeducted limited partnership losses at the time a limited partner disposes of a limited partnership interest increases the limited partner's adjusted cost base of the partnership interest, thereby reducing the capital gain (or increasing the capital loss) realized on the disposition.

The at-risk rules have been administered on the basis that they apply to tiered partnership structures in which a limited partner is, itself, another partnership. Under these structures, it has been the view of the department of finance that limited partnership losses would not be eligible to be carried forward by the partnership holding the limited partnership interest but would, instead, be reflected in the adjusted cost base of the limited partnership interest. In response to a recent Federal Court of Appeal decision which was inconsistent with this understanding, Budget 2018 proposes to clarify and ensure that the at-risk rules apply at each level of a tiered partnership structure. For a limited partner that is itself a partnership, its share of losses from the other partnership that can be allocated to its own members will be restricted by that limited partner's at-risk amount in the other partnership. In addition, measures will be introduced to treat limited partnership losses of a limited partner that is itself another partnership, as previously understood.

These measures will apply in respect of taxation years ending on or after 27 February 2018, including in respect of partnership losses incurred in a taxation year ending before 27 February 2018. Therefore, such losses will not be available to be carried forward to a taxation year ending on or after 27 February 2018 where the losses, for the year in which the losses were incurred, were allocated to a limited partner that is, itself, a limited partnership.

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 HWTs is not set out in the *Income Tax Act* (the Act). The CRA has a published administrative position which sets out the requirements for HWTs and the income tax consequences.

The Employer Life and Health Trust (ELHT) rules were introduced into the Act in 2010. In many respects the ELHT rules codify the HWT rules, but there are some differences. For example, while the ELHT rules limit the number of "key employees" who may be beneficiaries of an ELHT, the HWT policy contained no such restrictions.

Budget 2018 proposes the following:

New trusts

- The CRA's administrative position on HWTs is not effective to trusts created after budget day.
- New trusts will be required to satisfy the ELHT rules.

Existing HWTs

- The CRA's administrative position will no longer be effective after 31 December 2020.
- Existing HWTs will have until 31 December 2020 to either convert to an ELHT or wind up.
- Existing HWTs that do not convert or wind up by the end of 2020 will be taxed in the same manner as regular *inter vivos* trusts

It is unclear how existing HWTs will convert to ELHTs and there may be some situations where a HWT will fail to meet all the ELHT conditions. The Department of Finance has requested comments by 29 June 2018 on the transitional rules.

International tax measures

Cross-border surplus stripping using partnerships and trusts

The paid-up capital (PUC) of shares of a Canadian corporation can be returned to shareholders free of tax, and is also relevant in determining deductible interest expense under the thin capitalization rules.

The *Income Tax Act* contains a rule that is intended to prevent a corporation's nonresident shareholders from achieving a tax benefit by extracting (or "stripping") a Canadian corporation's surplus in excess of its PUC on a tax-free basis, or by artificially increasing the PUC of the shares. Some taxpayers have used partnerships or a trust in tax planning that seeks to preclude application of the anti-surplus stripping rule.

Budget 2018 proposes to amend the cross-border anti-surplus stripping rule, and the corresponding corporate immigration rule, to address situations where a partnership or trust is inserted into a corporate reorganization for the purpose of achieving a tax benefit that is intended to be denied by the anti-surplus stripping rule. The rule is to effectively "look through" such partnerships or trusts for this purpose by allocating the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries, as the case may be, based on the fair market value of their interests.

The measure will apply to transactions that occur on or after 27 February 2018.

Foreign affiliates

Budget 2018 proposes modifications to the foreign affiliate rules resulting from its "ongoing monitoring of developments in this area." However, no draft provisions were included in the Notice of Ways and Means Motion released with the budget information.

Investment business

Income from an investment business carried on by a foreign affiliate of a taxpayer is included in the foreign affiliate's FAPI. An investment business is generally defined as a business the principal purpose of which is to derive income from property. However, an investment business does not include a business carried on by a foreign affiliate if certain conditions are satisfied. One of these conditions, in general terms, is that the affiliate must employ more than five full-time employees or equivalent in the active conduct of the business. If the affiliate's investment activities require more than five full-time employees and the other conditions are satisfied, the affiliate's business is treated as an active business, and income from that business is not included in FAPI.

Budget 2018 proposes to introduce measures to address situations where certain taxpayers' foreign investment activities would not warrant more than five full-time employees, but by engaging in arrangements with other taxpayers each seeking to satisfy the more than five full-time employee test, financial assets are pooled in a common foreign affiliate. Taxpayers may combine their assets in a common affiliate, achieving sufficient scale to substantiate the more than five employee test in a single business, their respective returns are tracked to specific property and determined separately by reference to property contributed to the affiliate. The concern is that under contractual arrangements often accompanying such "tracking arrangements," the assets contributed by Canadian taxpayers are not truly pooled, and the affiliate is essentially used as a conduit entity to shift otherwise passive investment income offshore in a manner that the income could be later repatriated to Canada tax free.

The measure will apply for the purpose of the investment business definition so that, where income attributable to specific activities carried out by a foreign affiliate accrues to the benefit of a specific taxpayer under a tracking arrangement, those activities carried out to earn such income will be deemed to be a separate business carried on by the affiliate. Each separate business of the affiliate will therefore need to satisfy each relevant condition in the investment business definition, including the more than five employee test, in order for the affiliate's income from that business to be excluded from FAPI.

This measure will apply to taxation years of a taxpayer's foreign affiliate that begin on or after 27 February 2018.

Controlled foreign affiliate status

The FAPI of a foreign affiliate of a taxpayer is included in the taxpayer's income on an accrual basis only where the affiliate is a controlled foreign affiliate of the taxpayer. The Government expresses concern over situations where certain groups of Canadian taxpayers may have used tracking arrangements to avoid controlled foreign affiliate status. Under the tracking arrangement, each taxpayer purportedly retains control over its contributed assets and any returns from those assets accrue to its benefit, but ownership of the nonresident entity is spread among many unrelated investors such that no single group can be said to control the affiliate. This is sometimes effected through the establishment of separate cells or segregated accounts that track those contributed assets and respective returns.

To address this concern, Budget 2018 proposes to deem a foreign affiliate of a taxpayer to be a controlled foreign affiliate of the taxpayer if FAPI attributable to activities of the foreign affiliate accrues to the benefit of the taxpayer under a tracking arrangement. This measure is intended to ensure that each taxpayer involved in such a tracking arrangement is subject to accrual taxation in respect of FAPI attributable to that taxpayer.

This measure will apply to taxation years of a taxpayer's foreign affiliate that begin on or after 27 February 2018.

Trading or dealing in indebtedness

For purposes of the investment business definition, there are exceptions for regulated foreign financial institutions. Budget 2014 introduced rules for the purpose of the investment business definition requiring that a taxpayer satisfy certain minimum capital requirements in order to meet the regulated foreign financial institution exceptions. However, where principal purpose of a business carried on by a foreign affiliate is to derive income from trading or dealing in indebtedness, there is a separate and less stringent "regulated foreign financial institutions" exception that may be satisfied in order for the income from that business to not be FAPI.

To ensure consistency with the investment business rules, Budget 2018 proposes to add a similar minimum capital requirement to the trading or dealing in indebtedness rules that must be satisfied in order for the income from the business to be considered active business income and not FAPI.

This measure will apply to taxation years of a taxpayer's foreign affiliate that begin on or after 27 February 2018.

Reassessment period – nonresident non-arm's-length persons

After an initial assessment of a tax return, the CRA generally has a fixed period of either three or four years within which to make a reassessment. If a taxpayer incurs a loss in a taxation year and carries the loss back to a prior taxation year, the CRA has an additional three years to reassess that prior taxation year. This extended reassessment period for that prior year does not take into account the fact that the CRA generally has either six or seven years to reassess a return in respect of transactions between a Canadian taxpayer and a nonresident non-arm's-length person. Consequently, situations may arise where the CRA reassesses to reduce a loss in a subsequent taxation year that has been carried back to a prior taxation year, but is unable to reassess the prior taxation year to which the loss was carried back to reduce the application of that loss in that prior year.

Budget 2018 proposes to amend the *Income Tax Act* to allow an additional three years to reassess a prior taxation year of a taxpayer to reduce a loss carryback made from a subsequent taxation year where that subsequent taxation year has been reassessed in respect of a transaction involving a nonresident non-arm's-length person such that the loss in that subsequent year that was available for carryback to the prior taxation year is reduced. The rule will apply to losses carried back from a taxation year that ends on or after 27 February 2018.

Reassessment period – requirements for information and compliance orders

The CRA has a number of information-gathering tools at its disposal. A requirement for information may be issued by the CRA to require a person to provide specified information or documents. A compliance order can be sought by the CRA from a court where a person has failed to comply with an information request or a requirement for information.

Currently, where a taxpayer contests a requirement for information or a compliance order in court, the time allowed for the CRA to reassess a taxpayer is extended only for situations that involve requirements to produce foreign-based information. The time that the matter is before the court is added to the time allowed for the CRA to reassess the taxpayer — a "stop-the-clock" rule.

Budget 2018 proposes to amend the *Income Tax Act* to introduce a "stop-the-clock" rule that will apply for requirements for information generally, and to compliance orders. The rule will extend the reassessment period of a taxpayer by period of time during which the requirement or compliance order is contested by the taxpayer.

Foreign affiliates – reassessments

After an initial assessment, the CRA generally has a fixed period of either three or four years in which to make a reassessment. An extended period of an additional three years is allowed in respect of transactions between the taxpayer and nonresident non-arm's-length persons. This extended period does not apply in all circumstances to income arising in connection with a foreign affiliate.

Budget 2018 proposes to amend the *Income Tax Act* to extend the reassessment period for a taxpayer by three years in respect of income arising in connection with a foreign affiliate of a taxpayer.

Foreign affiliates – reporting requirements

Canadian taxpayers are required to file T1134 information returns for each year in respect of their foreign affiliates. These returns are due 15 months after the end of its taxation year.

Budget 2018 proposes to bring the information return deadline in respect of a taxpayer's foreign affiliates in line with the taxpayer's income tax return deadline, requiring the information returns to be filed within six months of the end of the taxpayer's taxation year. This measure will apply to taxation years of a taxpayer that begin after 2019.

Measures targeting financial institutions: artificial losses using equity-based financial arrangements

The Government proposes to improve existing anti-avoidance rules meant to prevent "a small group of taxpayers, typically Canadian banks and other financial institutions, from gaining a tax advantage by creating artificial losses that can be used against other income through the use of sophisticated financial instruments and structured share repurchase transactions." Specifically, Budget 2018 introduces legislation to clarify certain aspects of the dividend rental arrangement (DRA) rules by expanding the rules in respect of a synthetic equity arrangement (SEA), as well as securities lending arrangement (SLA) rules meant to prevent taxpayers from realizing artificial tax losses through the use of equity-based financial arrangements to circumvent these rules. It also includes amendments to dividend stop-loss rules for shares that are mark-to-market property.

Synthetic equity arrangements

Canadian corporations may generally receive dividends paid by another corporation resident in Canada tax free. DRA rules are meant to deny the inter-corporate dividend deduction to a taxpayer where the main reason for an arrangement is to enable the taxpayer to receive a dividend on a Canadian share, and the risk of loss or opportunity for gain or profit in respect of the share accrues to someone else.

Budget 2015 introduced amendments to strengthen the DRA rules targeting specific arrangements that some Canadian financial institutions purportedly entered into, referred to a SEA. In general, a SEA, in respect of a Canadian share owned by a taxpayer, is considered to exist where the taxpayer (or a non-arm's-length taxpayer) enters into one or more agreements that have the effect of providing to an investor all or substantially all of the risk of loss and opportunity for gain or profit in respect of the Canadian share. However, there are certain exceptions to the SEA rules, including a so-called "no tax-indifferent investor" exception, such that if conditions are satisfied, a deduction may be claimed in respect of dividends received on the share. The no tax-indifferent investor exception is provided where a taxpayer holds a Canadian share and can establish that no tax-indifferent investor has all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share because of the SEA (or a specified SEA).

The government expresses a concern that a position could be taken that this exception can be met where a tax-indifferent investor obtains all or substantially all of the risk of loss and opportunity for gain or profit of a Canadian share from a counterparty otherwise than because of a SEA or a specified SEA. Budget 2018 therefore proposes an amendment to the no tax-indifferent investor exception in the SEA rules to clarify that the exception cannot be satisfied when a tax-indifferent investor obtains all or substantially all of the risk of loss or opportunity for gain or profit in respect of a Canadian share in any way. This would include circumstances where a tax-indifferent investor has not entered into a SEA or a specified SEA in respect of the share.

The proposed amendments will apply to dividends that are paid, or become payable, on or after Budget Day.

Securities lending arrangements

Budget 2018 also proposes to broaden the SLA definition by introducing a concept of "specified SLA." A specified SLA is defined to mean an arrangement, other than a SLA, under which (a) a person transfers or lends a particular share described in paragraph (a) of the definition "qualified security" to another person, (b) it may reasonably be expected that the other person will transfer or return to the person a share that is identical to the particular share, and (c) the person's risk of loss or opportunity for gain or profit with respect to the share is not changed in any material respect.

The amendments are designed to target certain securities lending or repurchase arrangements that are designed to fail the requirements of the current SLA definition. The concern is that taxpayers may otherwise claim an inter-corporate dividend deduction on the dividends received on the acquired Canadian share, resulting in tax-free dividend income, while also deducting the amount of dividend compensation payments made under the arrangement. As a result of this amendment, when a taxpayer receives dividends on a Canadian share acquired under such an arrangement, the DRA rules will generally apply. Therefore, the inter-corporate dividend deduction will be denied, resulting in a dividend income inclusion that will appropriately offset the available deduction for the amount of the corresponding dividend compensation payments made to the counterparty under the arrangement.

Budget 2018 also includes rules to clarify the interaction of two rules governing the deductibility of dividend compensation payments made by a taxpayer under a SLA. Under the first rule, a taxpayer that is a registered securities dealer is permitted to deduct up to two-thirds of a dividend compensation payment to a counterparty. The second rule applies when a securities lending arrangement is a DRA. In these circumstances, the second rule generally permits the taxpayer, whether or not it is a registered securities dealer, to fully deduct any dividend compensation payment made to the counterparty. The proposed amendment will clarify that this first rule does not apply when the second rule applies.

The proposed amendments to the SLA rules will apply to dividend compensation payments that are made on or after Budget Day. However, if the securities lending or repurchase arrangement was in place before Budget Day, the amendments will apply to dividend compensation payments that are made after September 2018.

Stop-loss rule on share repurchase transactions

Generally, Canadian corporations may receive dividends paid by another corporation resident in Canada free of tax. Yet dividends paid may also reduce the value of a share of a Canadian corporation. To prevent abuses, dividend stop-loss rules have been introduced to reduce, in specific cases, the amount of a tax loss realized on the disposition of a Canadian share by an amount equal to the tax-free dividends received (or deemed to have been received) on the share before the disposition.

Where a share is held as a mark-to-market property, specific stop-loss rules may apply in all cases where the taxpayer is deemed to have received a dividend on a share repurchase (i.e., under subsection 84(3)). Based on a formula in subsection 112(5.2), the dividend stop-loss rule generally denies only the portion of the tax loss realized on a share repurchase equal to the excess of the original cost of the shares over their paid-up capital. This would generally allow the loss up to the portion of the tax loss equal to the mark-to-market income previously realized on the shares. However, a concern is that financial institutions may otherwise hedge such gain or loss in a manner that would offset any mark-to-market income realized on the share. Such an arrangement would effectively allow tax-free dividend income and an offsetting taxable loss on the share on a share repurchase.

Budget 2018 proposes to amend the stop-loss rule pertaining to shares held as mark-to-market property so that the tax loss otherwise realized on a share repurchase is generally decreased by the dividend deemed to be received on that repurchase (under subsection 84(3)) when that dividend is eligible for the inter-corporate dividend deduction.

The measure will apply in respect of share repurchases that occur on or after Budget day.

Tax measures for individuals and trusts

Personal income tax rates

There are no individual income tax rate or tax bracket changes in this budget. The brackets will continue to be indexed for inflation. See Table D for the 2018 federal rates and the Appendix for the top combined marginal rates by province and territory.

Table D

Federal personal income tax rates	
	2018
Up to $46,605	15.0%
$46,606 to $93,208	20.5%
$93,209 to $144,489	26.0%
$144,490 to $205,842	29.0%
Over $205,842	33.0%

Budget 2018 includes the following tax credit proposals:

- **Medical expense tax credit** – The list of expenses eligible for the medical expense tax credit is expanded to include a variety of expenses relating to service animals specially trained to perform tasks for a patient with a severe mental impairment (i.e., to assist them in coping with their impairment). This measure will apply to eligible expenses incurred after 2017.

- **Mineral exploration** – The mineral exploration tax credit, equal to 15% of 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

Effective for tax returns filed for the 2021 and subsequent taxation years, additional information reporting will be required for express trusts that are either resident in Canada or nonresident trusts if they are required to file a T3 return. Where the reporting requirements apply, 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 to exert control over trustee decisions regarding the allocation of trust income or capital (i.e., a protector).

These changes will create a T3 filing requirement for many trusts which are generally not required to file a T3 return as they do not earn income or make distributions in a year.

Certain types of trusts will be excluded from these proposed additional reporting requirements, including:

- Mutual fund trusts, segregated funds and master trusts
- Trusts governed by registered plans
- Lawyers' general trust accounts
- Graduated rate estates and qualified disability trusts
- Trusts that qualify as nonprofit organizations or registered charities
- Trusts that have been in existence for less than 3 months or that hold less than $50,000 in assets throughout the taxation year (with the assets confined to deposits, government debt obligations and listed securities)

New penalties ($25 per day — minimum $100 and maximum $2,500) will be introduced for failure to file a T3 return including a required beneficial ownership schedule if required. If the failure to file was made knowingly or due to gross negligence, an additional penalty will apply equal to 5% of the maximum fair market value of the property held, with a minimum penalty of $2,500.

To implement these new reporting requirements and improve the audit and administration of trusts, the Government will be funding the development of an electronic platform for processing T3 returns.

Other personal measures

Canada Workers Benefit

The working income tax benefit, which is a refundable tax credit supplementing low-income workers, will be enhanced and renamed the Canada Workers Benefit.

The changes include:

- For 2019, the maximum benefit will be $1,355 for a single individual without dependants (an increase of $170 in 2019) and $2,335 for families. In addition, the disability supplement will be increased to $700 in 2019.

- The benefit will be reduced for single individuals with income in excess of $12,820 and families with income over $17,025. The credit will be fully eliminated for individuals with income in excess of $24,111 and families with income in excess of $36,483.
- Access to the benefit will also be improved. While the working income tax benefit is required to be claimed on the individual's tax return, Budget 2018 proposes to allow the CRA to determine an individual's eligibility for the Canada Workers Benefit even when not specifically claimed, effective for 2019 and later years.

Under the current rules, individuals (with no dependents) who are enrolled as full-time students at a designated educational institution for a total of more than 13 weeks in a taxation year will not be eligible for the benefit. Budget 2018 proposes that designated educational institutions be required to report to the CRA prescribed information regarding students' enrolment after 2018.

Contributions to enhanced portion of Quebec pension plan (QPP)

Budget 2018 proposes to amend the *Income Tax Act* to specifically permit the deduction for employee contributions, and the "employee" share of contributions made by self-employed persons, to the enhanced portion of the QPP. This measure is effective for 2019 and subsequent taxation years (when contributions to the enhanced portion of the QPP will begin to be phased in). A personal tax credit will continue to apply to the employee share of the contributions to the base (i.e., existing) QPP. For self-employed individuals, this measure will ensure the individual is able to deduct both the employee and employer share of contributions to the enhanced portion of the QPP.

Registered Disability Savings Plan (RDSP) — permitted plan holders

Currently, the *Income Tax Act* includes a temporary measure that permits certain family members (parents, spouses and common-law partners) to be the plan holder of an RDSP for adults who might not be able to enter into contracts. This temporary measure is scheduled to expire at the end of 2018. The 2018 federal budget proposes to extend the temporary measure (by five years) to the end of 2023. If a qualifying family member becomes a plan holder of an RDSP before the end of 2023, they can remain as the plan holder after 2023.

Child benefits

- **Retroactive eligibility** – Eligibility requirements for the former Canada Child Tax Benefit, the National Child Benefit supplement and the Universal Child Care Benefit will be amended retroactively to ensure that foreign-born status Indians residing legally in Canada who are neither Canadian citizens nor permanent residents will be eligible for those benefits if all other eligibility requirements are met. These individuals are currently eligible for the Canada Child Benefit, which replaced the previous system of child benefits.

- **Provincial/territorial access to taxpayer information** – The *Income Tax Act* will be amended to permit the federal government to share taxpayer information related to the Canada Child Benefit with the provinces and territories, beginning 1 July 2018. Access to the information is to be provided solely for the purpose of permitting the provinces and territories to administer their social assistance payment regimes.

Charities and non-profit organizations

Budget 2018 proposes the following measures relating to charities:

- **Municipalities as eligible donees:** Transfers of property made by a charity to a municipality will be allowed to be considered qualifying expenditures made to an eligible donee for the purposes of the charity status revocation tax, even if the municipality is not a registered charity, but subject to the approval of the Minister of National Revenue on a case-by-case basis. (Applicable to transfers made after 26 February 2018.)

- **Universities outside Canada:** The requirement that universities outside Canada be prescribed in the *Income Tax Regulations* to be considered qualified donees will be removed, as they are already listed on the Government of Canada website. (Applicable as of 27 February 2018.)

- **Nonprofit journalism:** It is the Government's intention over the next year to explore new models that enable private giving and philanthropic support for trusted, professional, nonprofit journalism and local news. Budget 2018 indicates that this support could include providing Canadian newspapers with charitable status for not-for-profit provision of journalism.

Finally, Budget 2018 indicates that it will provide, in the coming months, a response to the recommendations made in 2017 by the consultation panel on the political activities of charities.

GST/HST and excise duty legislative amendments

GST/HST measures

Budget 2018 proposes the following measures regarding GST/HST.

Investment limited partnerships

Budget 2018 proposes to implement and modify the 8 September 2017 draft legislative and regulatory proposals relating to investment limited partnerships so that management and administrative services rendered by the general partner on or after 8 September 2017 be taxable based on the fair market value of such services. Such services rendered before 8 September 2017 will not be taxable unless the general partner charged GST/HST on such services before that date (that is, no retroactive relief before such date if tax was charged). This will be implemented through changes to subsection 272. 1 (3) of the *Excise Tax Act* and new subsection 272.1 (8) to ensure such services are deemed to not be done by the general partner as a member of the investment limited partnership.

Investment limited partnerships are defined to be those promoted as collective investment vehicles, or a limited partnership where 50% or more of the total interests are owned by listed financial institutions.

In addition, Budget 2018 proposes that investment limited partnerships, other than nonresident investment limited partnerships (those where 95% or more of the total value of all interests is held by nonresident members) will be added to the definition of "investment plans" for purposes of the special GST/HST rules applicable to listed financial institutions.

Budget 2018 proposes to allow an investment limited partnership to make an election to advance as of 1 January 2018 the qualification as a listed financial institution and thus, the application of the special HST rules. In absence of such election, the special HST rules will generally apply to investment limited partnerships effective 1 January 2019.

Cannabis products not zero-rated for GST/HST

Budget 2018 proposes changes to zero-rating schedules will be made to ensure products do not qualify as basic groceries or qualifying agricultural products (e.g., seeds).

Consultations on GST/HST section 186 holding corporation rules

Budget 2018 proposes consultations on the "holding corporation" rules that allow a parent corporation to take ITCs to recover the GST/HST paid on expenses incurred in relation to shares or indebtedness of a related subsidiary operating company that is engaged in commercial activities. The consultation relates to:(a) whether the rules should be limited to corporations; (b) the requisite degree of relationship between the parent and the operating commercial corporation; and (c) to clarify which expenses are in respect of the shares or indebtedness of the related commercial operating corporation (in response to recent court cases, presumably).

Budget 2018 proposes the following measures regarding excise duties on tobacco and cannabis products

In Budget 2018, the federal government committed to:

- Advance the existing inflation adjustments on tobacco excise duties from every 5 years (under the Economic Action Plan 2014) to an annual basis to take effect on 1 April of each year; however, effective 28 February 2018 an adjustment will be made to account for inflation since the last adjustment in 2014. Budget 2018 also proposes to increase the excise duty rate by $1 per carton (200 cigarettes) and corresponding rates to other tobacco products. In addition, inventories on hand at the end of 27 February 2018 will be subject to an inventory tax of $.011468 per cigarette, this tax payable by 30 April 2018 in accordance with the cigarette inventory tax mechanism in the *Excise Act* 2001.
- Impose excise duties on federally licensed cannabis producers once non-medicinal cannabis is available for legal retail sale in a province. The duties will be paid by the licensee who packaged the product for final retail sale at the higher of a flat rate based on a dollar per gram (seed/seedling) basis or an ad valorem imposed on the dutiable amount of the transaction. Certain exemptions will apply to federally regulated prescription drugs with DIN numbers and for products containing less than 0.3% THC concentration.

Pending legislative and regulatory proposals and other previously announced measures

The government will proceed with the following pending legislative and regulatory proposals and other previously announced measures, as modified to take into account consultations and deliberations since their release.

Federal backstop carbon pricing system

On 15 January 2018, the Minister of Environment and Climate Change, Catherine McKenna, and the Minister of Finance, Bill Morneau, released draft legislative and regulatory proposals relating to the proposed federal backstop carbon pricing system for public comment, as a follow-up to the technical paper released on 18 May 2017. Minister McKenna also released for comment a regulatory framework describing the proposed federal approach to carbon pricing for large industrial facilities under the output-based pricing component of the system. The federal system is intended to be applied in the fall of 2018 in the provinces and territories that notified the federal government (by the end of March 2018) of their decision to adopt such system, and as of January 2019 in those that don't have their own system in place in 2018 that meets the federal benchmarks.

The consultation period for the proposals to implement the federal backstop carbon pricing system closed 12 February 2018, and the consultation period for the output-based pricing system regulatory framework will close by 9 April 2018.

Learn more in EY Tax Alert 2018-02.

Legislative proposals relating to the *Income Tax Act* re income-sprinkling and private corporations

On 13 December 2017, federal Finance Minister Bill Morneau released new draft legislation revising the income-sprinkling measures proposed on 18 July 2017. The revised measures are intended to simplify and clarify the application of the July proposals (notably with respect to what will be excluded from the broadened tax on split income) while keeping the general scheme of the original proposals. (Generally effective for 2018 and later years.)

Read more in our Tax Alert 2017 No. 52.

Agriculture and Agri-Food Canada announcement re additional support to farmers

On 6 November 2017, Agriculture and Agri-Food Canada announced an extension of the existing tax deferral for taxpayers who receive compensation under the *Health of Animals Act* due to the 2016 and 2017 bovine tuberculosis outbreak in Alberta and Saskatchewan that forced the destruction of livestock. Taxpayers will have the option to include in income the compensation amounts received in 2016 or 2017 over three years (83% in 2018, 11% in 2019, and 6% in 2020).

Notice of Ways and Means Motion re 2017 fall economic statement

On 24 October 2017, the government tabled its fall economic statement together with a notice of ways and means motion (NWMM). The NWMM included measures to implement the reduction in the small business corporate income tax rate (previously announced on 16 October 2017), in addition to bringing forward by two years the start date for indexation of the Canada child benefit.

Specifically, the NWMM included the following income tax measures:

- **Small business tax rate** — Reduction in the current 10.5% rate applicable on small business income of a Canadian-controlled private corporation to 10%, effective 1 January 2018, and to 9%, effective 1 January 2019.
- **Non-eligible dividend rate** – Reduction in the gross-up factor for non-eligible dividends from 17% to 16% for 2018 and to 15% for 2019 and subsequent years; the effective dividend tax credit (expressed as a percentage of the grossed-up amount of a non-eligible dividend) will be reduced from 10.5% to 10% for 2018 and 9% for 2019 and subsequent years.
- **Canada child benefit** – Early start on 1 July 2018 of the annual indexing for the Canada child benefit, rather than on the currently legislated date of 1 July 2020.

Remaining measures from the 8 September 2017 Legislative proposals relating to the *Income Tax Act*

Outstanding measures concerning the exemption of the military salaries of all Canadian Armed Forces personnel and police officers deployed on named international operational missions from federal income taxes, up to and including the pay level of Lieutenant-Colonel (General Service Officers) of the Canadian Forces. (Applicable to the 2017 and subsequent taxation years).

Remaining measures from the 16 September 2016 Legislative proposals relating to technical amendments to the *Income Tax Act* and *Income Tax Regulations*

Outstanding measures concerning foreign spinoffs and shareholder benefit rules (applicable to divisions of non-resident corporations that occur after 23 October 2012).

Read more in our Tax Alert 2016 No. 41.

Remaining measures from the 2016 federal budget (tabled 22 March 2016)

Outstanding measures concerning new reporting requirements for corporate and partnership life insurance beneficiaries that are not policyholders, and the expansion of accelerated CCA Classes 43.1 and 43.2 for clean energy assets (generally applicable after 21 March 2016).

Outstanding measures concerning the GST/HST joint venture election that were first announced in the 2014 budget under the previous government – the renewed intention to proceed with these measures was also confirmed by the current government in the 2017 budget, in addition to the 2016 budget.

Read more in our Tax Alert 2016 No. 14.

Webcast

27 February webcast: The evening following the finance minister's address, members of the EY tax team will record their analysis and insights on the tax measures in the 2018 budget. View our webcast at **ey.com/ca/budget**.

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 Ryan Ball and Gabriel Baron.

Learn more

For more information on the above measures or any other topics which may be of concern, 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

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

	Ordinary income			2018		
	2017	2018	Increase (decrease)	Eligible dividends	Ordinary dividends	Capital gains
	%	%	%	%	%	%
Federal only	33.00	33.00	0.00	24.81	26.64	16.50
BC	47.70	49.80	2.10	34.20	43.73	24.90
Alberta	48.00	48.00	0.00	31.71	41.64	24.00
Saskatchewan	47.75	47.50	(0.25)	29.64	39.76	23.75
Manitoba	50.40	50.40	0.00	37.78	45.92	25.20
Ontario	53.53	53.53	0.00	39.34	46.84	26.76
Quebec	53.31	53.31	0.00	39.83	43.94	26.65
NB	53.30	53.30	0.00	33.51	46.88	26.65
NS	54.00	54.00	0.00	41.58	47.33	27.00
PEI	51.37	51.37	0.00	34.22	44.26	25.69
NL	51.30	51.30	0.00	42.61	43.81	25.65
NWT	47.05	47.05	0.00	28.33	35.98	23.53
Nunavut	44.50	44.50	0.00	33.08	36.78	22.25
Yukon	48.00	48.00	0.00	28.92	41.42	24.00

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