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2018 Federal Budget: Tax Highlights

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As anticipated, today's federal budget (Budget 2018) focuses on a few targeted areas, including the taxation of passive investments made by private corporations, and does not contain any measures in response to the enactment of tax reform in the United States or relating to the OECD BEPS initiative. Significantly, Budget 2018 substantially narrows the scope of the Department of Finance's 2017 passive investment proposals. The 2017 proposals were exceedingly complex, and effectively proposed a punitive tax on income generated from investments made using after-tax business earnings of a private corporation. Budget 2018 presents a much simpler set of proposals.

The principal tax changes announced in Budget 2018 of interest to the business community are summarized below.

Private Company Passive Investment Income

In 2017 the Department of Finance released a set of controversial and convoluted proposals aimed at addressing its concern that individuals who carry on business through a corporation can obtain a tax deferral advantage by retaining their after-tax business income in the corporation to make passive investments. The 2017 proposals were exceedingly complex, and effectively proposed a punitive tax on income generated from investments made using after-tax business earnings of a Canadian-controlled private corporation (CCPC) in excess of $50,000 per year. Budget 2018 presents a much simpler set of proposals. These proposals will phase out access to the small business deduction for CCPCs that earn more than $50,000 of investment income, and will modify the current rules for the refundable tax on dividends paid by CCPCs. These measures will apply to taxation years that begin after 2018.

Limit on the Small Business Deduction

A CCPC is entitled to a preferential tax rate on up to $500,000 of qualifying active business income, referred to as the "small business deduction." This amount must be shared by associated corporations, and is reduced where the CCPC and its associated group have taxable capital employed in Canada in excess of $10 million. Budget 2018 proposes to also reduce the amount of the small business deduction for a CCPC that, together with other corporations within its associated group, earns investment income in a taxation year in excess of $50,000. This reduction will operate alongside the reduction for taxable capital in excess of $10 million, so that the reduction to the small business deduction will be the greater of the reduction under these two rules.

For each $1 of investment income over $50,000, the small business deduction limit will be reduced by $5. Thus, for example, a CCPC with investment income of $100,000 will have its small business deduction limit reduced to $250,000, and a CCPC with investment income of $150,000 or more will lose the small business deduction entirely.

Investment income for purposes of these rules will consist generally of net taxable capital gains and income from property, but exclude gains and losses from property used in an active business in Canada or shares of a connected CCPC that derive their value from such a business as well as tax-free intercorporate dividends received from connected corporations. Net capital losses from other taxation years will not be available to reduce investment income. In addition, income from a life insurance policy that is not an exempt policy will be included in computing investment income.

Refundable Taxes and Dividend Refund Rules

For purposes of the *Income Tax Act* (Canada) (ITA), a CCPC is subject to additional refundable taxes on its investment income, and these taxes are included in the CCPC's refundable dividend tax on hand (RDTOH) account. The CCPC is entitled to a refund of $38.33 of the refundable taxes included in its RDTOH account for every $100 of dividends paid to its shareholders. The purpose of the additional refundable tax and dividend refund mechanism is to provide integration of the corporate and personal tax payable on investment income earned by a CCPC, so that a shareholder should generally be indifferent as to whether the investment income is earned personally or through a corporation.

The Department of Finance's 2017 passive investment proposals would have eliminated or restricted the availability of the RDTOH rules where a CCPC reinvests active business income in passive assets. These proposals, which would have imposed an effective tax rate of approximately 73% on investment income earned by a CCPC, were heavily criticized by the business community and the press.

Budget 2018 proposes a more limited restriction of the RDTOH system than the 2017 passive investment proposals. The Budget 2018 proposal is intended to ensure a CCPC will not be entitled to claim a dividend tax refund in respect of "eligible dividends" that were generated out of the CCPC's active business income taxed at the general corporate rate. With limited exceptions, a CCPC will only be entitled to a dividend tax refund to the extent the dividend is paid out of passive investment income.

A "non-eligible dividend" is a dividend that is paid by a CCPC out of its active business income taxed at the small business rate, or its investment income (excluding any eligible dividends received by the CCPC). An individual receiving a non-eligible dividend in 2018 generally will be subject to tax of approximately 45% of the amount of the dividend (depending on the province of residence) if the dividend is taxed at the top marginal rate. "Eligible dividends" are generally paid out of CCPC's active business income taxed at the general corporate rate, or out of eligible dividends received from another corporation. An individual receiving an eligible dividend in 2018 generally will be subject to tax of approximately 38% of the amount of the dividend (depending on the province of residence) if the dividend is taxed at the top marginal rate.

Currently, a CCPC may claim a dividend refund whether the dividend paid is an eligible dividend or a non-eligible dividend. This was perceived as providing an inappropriate tax benefit to the extent a CCPC receives a dividend refund where it pays an eligible dividend out of income that was not subject to the additional refundable tax.

Budget 2018 proposes to eliminate any dividend refund on eligible dividends paid by a CCPC, unless the eligible dividend is paid out of eligible dividends received by the CCPC on portfolio investments that were subject to the additional refundable tax. To implement this proposal, Budget 2018 proposes to create two separate RDTOH accounts to track the refundable taxes paid by a CCPC from different sources. The first RDTOH account tracks refundable taxes paid on eligible portfolio dividends received by a CCPC. A CCPC will be entitled to a dividend refund for taxes in this RDTOH account when it pays an eligible or a non-eligible dividend. The second RDTOH account tracks refundable taxes on all other sources of investment income. A CCPC will only be entitled to a dividend refund for taxes in this RDTOH account when it pays a non-eligible dividend. A mechanism is included in Budget 2018 to preserve the character of dividends paid out of these two accounts between connected corporations.

New Reporting Requirements for Trusts

Budget 2018 introduces new tax reporting requirements for trusts, which are intended to improve the collection of beneficial ownership information by the government. A trust that does not earn income or make distributions in a taxation year is generally not currently required to file an annual T3 trust return. A trust is required to file a T3 return if it has tax payable in the year or if it distributes income or capital to its beneficiaries. The new reporting requirements will apply to express trusts that are resident in Canada and to non-resident trusts that are currently required to file a T3 return, and require each such trust to report the identity of all of its trustees, beneficiaries and settlors, as well as each person who has the ability (whether through the trust terms or a related agreement) to exercise control over trustee decisions regarding the appointment of income or capital of the trust, such as a protector. Exemptions are proposed in respect of certain types of trusts, including mutual fund trusts, segregated funds, trusts governed by registered plans, graduated rate estates and qualified disability trusts, non-profit organizations and registered charities, and certain trusts that have been in existence for less than three months or that hold less than $50,000 in specified passive assets. These reporting requirements will apply in respect of the 2021 and subsequent taxation years.

Tiered Partnerships and At-Risk Rules

The ITA contains "at-risk" rules that prevent a limited partner in a partnership from deducting losses allocated by the partnership where they exceed the partner's "at-risk amount" (generally, invested capital adjusted for income, losses and distributions, reduced to the extent certain financial assistance is available to the partner). Generally, restricted losses are allowed to be deducted in later years if they no longer exceed the partner's at-risk amount. How these rules apply where a partnership is itself a partner in a lower-tier partnership has been uncertain. The Canada Revenue Agency (CRA) took the position that the losses of the lower-tier partnership that were restricted were no longer available, because the rules allowing them to be carried forward did not apply to partnerships. In a recent case (*Green*), the Federal Court of Appeal disagreed with the CRA and in effect looked through the tiered partnerships to allow restricted losses to be claimed.

The *Green* decision might allow partnership losses to be claimed in circumstances that would be inconsistent with the purpose of the at-risk rules, and so a legislative response was expected. Unfortunately, the Department of Finance has taken an approach that appears to be harsher than is necessary to protect the integrity of the at-risk rules. Rather than allow a top-tier partnership to maintain a suspense account so that losses could be used in future periods if the at-risk amount increases - in the way other partners can - Budget 2018 proposes that any excess losses will simply be disallowed. The denied losses will not reduce the top-tier partnership's tax cost of its interest in the lower-tier partnership, meaning that in many cases the losses effectively will be converted to an increased capital loss or reduced capital gain at the time the partnership interest is disposed of. This is consistent with CRA's position prior to the decision in *Green*. Budget 2018 does not explain why this more restrictive approach has been taken.

The rules will apply to taxation years ending on or after February 27, 2018 (Budget Day). In addition, transitional rules will apply to losses incurred but not claimed prior to Budget Day to fold them into the new system.

Cross-Border Surplus Stripping Using Partnerships and Trusts

New proposals are introduced that are intended to backstop the existing cross-border corporate surplus stripping provisions in section 212.1 of the ITA in respect of transactions involving partnerships and trusts. The current rules prevent a non-resident shareholder of a Canadian resident corporation from extracting corporate surplus in excess of the paid-up capital (PUC) of its shares on a tax-free basis, or artificially increasing the PUC of its shares, by transferring the shares to another Canadian resident corporation with which the non-resident shareholder does not deal at arm's length. Where applicable, the provisions can result in a deemed dividend to the non-resident shareholder or may suppress the PUC that would otherwise be created as a result of the transaction. Budget 2018 proposes to extend these provisions by adding look-through rules that will apply where a non-resident disposes of an interest in a partnership or trust that owns shares of a Canadian corporation, to preclude avoidance of the rule through internal reorganizations involving a transfer of shares through an intermediate entity such as a partnership or trust. The proposals will allocate the assets, liabilities, and transactions of a partnership or trust to its members or beneficiaries based on the relative fair market value of their respective interests. This measure will apply to transactions that occur on or after Budget Day.

Foreign Affiliates

Extended Reassessment Period

The CRA generally has the right to reassess a taxpayer within three or four years from the date of the initial assessment of their tax return. However, in certain cases, the CRA is afforded an additional three years to reassess. Budget 2018 proposes to extend the reassessment period of taxpayers for taxation years beginning on or after Budget Day in respect of income arising in connection with their foreign affiliates (FAs) - essentially foreign corporations in respect of which they have at least a 10% interest - on the basis that audits in respect of FAs are often time consuming because of their complexity and the challenge of obtaining foreign-based information.

Reporting Requirements

Canadian taxpayers are currently required to file information returns (i.e., Form T1134) in respect of their FAs within 15 months after their taxation year-end. This extended filing period was provided to accommodate the significant amount of time and resources required for taxpayers to comply with the FA rules. Budget 2018 proposes to shorten the filing deadline for the T1134 to six months after a taxpayer's taxation year-end for taxation years that begin in 2020. Accordingly, on one hand, Budget 2018 proposes to extend the reassessment period in respect of FAs because the associated audits are time consuming for the CRA, while, on the other hand, Budget 2018 proposes to shorten the time for which taxpayers may gather the necessary data to file the very information returns that are designed to expedite and focus the CRA's audit efforts in this area.

Anti-Avoidance Measures

Budget 2018 proposes the addition of certain anti-avoidance measures relevant to Canada's FA regime applicable for taxation years of an FA that begin on or after Budget Day, as follows:

- A rule that would deem there to be a separate business in respect of specific activities carried out by an FA if income attributable to such activities accrues to the benefit of a specific taxpayer under a tracking arrangement (which may be achieved through separate cells or segregated accounts). As a result, the FA will need to satisfy each relevant condition under the investment business definition, including the six employee test, in order for the FA's income from that business to be excluded from foreign accrual property income (FAPI). Though this rule seems to be aimed at pooling arrangements entered into between unrelated parties it may adversely affect certain legitimate treasury structures of Canadian multinationals.
- A similar rule that would deem an FA of a taxpayer to be a controlled foreign affiliate of the taxpayer if FAPI attributable to activities of the FA accrues to the benefit of the taxpayer under a tracking arrangement. This measure is intended to ensure that a taxpayer involved in such a tracking arrangement is subject to accrual taxation in respect of FAPI attributable to that taxpayer. This proposal would effectively substitute the mechanical FAPI attribution rules for the more subjective offshore investment fund property rules that might otherwise apply.
- A rule that would impose a minimum capital requirement as part of the trading or dealing in indebtedness rules that is similar to the one required in order to qualify for the regulated foreign financial institutions exception under the investment business definition.

Rules Targeting Transactions Relating to the DRD

Synthetic Equity Arrangements

The 2015 federal budget announced a proposal that denied the inter-corporate dividend-received deduction (DRD) to a Canadian corporation on dividends received on shares in respect of which the Canadian corporation has entered into a "synthetic equity arrangement." In general terms, a synthetic equity arrangement in respect of a share is one or more arrangements entered into by a person that has the effect of transferring all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share to another person. However, the DRD is not denied where the taxpayer establishes that no tax-indifferent person (a non-resident person or tax exempt person) has acquired all or substantially all of the risk of loss or opportunity for gain or profit in respect of the share because of the synthetic equity arrangement (or a connected arrangement). The government is concerned that this exception can be met where a tax-indifferent investor obtains all or substantially all the risk of loss and opportunity for gain or profit from a counterparty in a manner that does not involve a synthetic equity arrangement (or a connected arrangement). To address this concern, Budget 2018 proposes to amend the wording of the exception to only apply where the taxpayer establishes that no tax-indifferent investor has acquired all or substantially all of the risk of loss or opportunity for gain or profit in respect of the share in any way. This measure will apply in respect of dividends paid or payable after Budget Day.

Securities Lending Arrangements

The ITA contains "securities lending arrangement" (SLA) rules that are intended to apply to stock loan and repurchase transactions. Where a Canadian corporate taxpayer acquires shares of another Canadian corporation pursuant a transaction that is an SLA for the purposes of the ITA, the taxpayer is denied the DRD in respect of dividends received on those shares and its deduction of compensation payments made to the counterparty under the stock loan is limited. The government is concerned that stock loan transactions can be structured to not be an SLA for the purposes of the ITA and, as a result, a taxpayer can both claim the DRD and deduct the compensation payments made under the stock loan. Budget 2018 proposes to amend the ITA to ensure the rules denying the DRD and limiting the deduction of dividend compensation payments also apply to certain stock loan transactions (defined as “specified securities lending arrangements”) that are not otherwise SLAs. This measure will apply on or after Budget Day for new arrangements and will begin to apply for existing arrangements after September 2018.

Stop-Loss Rules on Share Repurchase Transactions

The DRD generally allows a corporation to deduct dividends received from another corporation resident in Canada in computing its taxable income. To prevent abuses of the DRD, dividend stop-loss rules generally deny any tax loss realized on the disposition of a share by the amount of any tax-free dividends received (or deemed to have been received) on the share before the disposition. In addition, where the share is held as mark-to-market property and a dividend is deemed to have been received on a share repurchase, the tax loss is generally denied to the extent the original cost of the share exceeds its PUC. The portion of the tax loss equal to the mark-to-market income previously realized on the share is allowed on the premise that tax has been paid on that income. However, if that income is fully offset under a hedge, this premise may not hold true. As a result, Budget 2018 proposes to reduce the tax loss otherwise realized on the share repurchase by the dividend deemed to have been received on the repurchase when the dividend is eligible for the DRD. This measure applies in respect of share repurchases that occur on or after Budget Day.

We are pleased to welcome our new partner, Bobby Sood, to our tax practice. With 19 years of experience in the Tax Services Division at the Department of Justice, Bobby brings a wealth of knowledge and specialized expertise to our team of 11 industry-leading tax dispute lawyers.

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