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Federal Budget Income Tax Measures – February 27, 2018

Background

On February 27, 2018 the Federal Budget was released. Included in the budget are tax changes that were anticipated as part of the original July 2017 proposals to restrict the ability of Canadian Controlled Private Corporations to accumulate passive investment assets. Additional basic information on this topic can be found on the Government of Canada, Department of Finance website at https://www.fin.gc.ca/n18/docs/18-008_9-eng.pdf.

It was announced in 2017 that the Small Business tax rate would be reduced in 2018 and 2019. In 2017 the rate was 15% in Ontario. For 2018 the rate is now 13.5% and for 2019 the rate is 13%. The result of these changes is that personal tax rates on non-eligible dividends have increased for 2018 and 2019. For comparison, the tax rate on active business income not eligible for the Small Business Deduction is 26.5% in Ontario, and the tax rates on eligible dividends are correspondingly lower.

Summary and Comments

The good news is that the proposed changes are less onerous than anticipated. In general terms, the government has outlined a plan that will further restrict access to the Small Business Deduction and hence the low rates of corporate income tax. As well, the budget proposes to stream the accumulation of income at the Small Business tax rate with the payment of non-eligible dividends.

The bad news is that it is obvious by these measures that the government continues to be focused on obtaining additional tax revenues, and on obtaining those revenues sooner than later, from those earning in the approximate income levels of $50,000 to a maximum level of $500,000 of income annually as those with earning or holding above these levels are very likely not to be impacted at all. This is in direct conflict with their stated goal of “closing loopholes” being exploited by the top 1% of earners.

The following proposals related to the small business deduction and the payment of dividends are very technical in nature. Please do not hesitate to contact us for further detail.

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Budget Impact on the Small Business Deduction/Small Business Tax Rate

The budget proposes to limit the ability of private corporations with passive investment income from accessing the Small Business Deduction. Currently the Small Business Deduction is phased out based on a capital tax formula where the taxable capital of a corporation exceeds $10 million. The new proposal in addition to the capital tax formula is an additional formula that will reduce the small business deduction where passive investment income exceeds $50,000 in a given tax year. The small business deduction is completely eliminated when passive investment income reaches $150,000 in a tax year. For those earning less than $50,000 of passive investment income, there will be no change in their tax treatment. In addition, capital gains from the sale of assets used in the active business or from the sale of shares of a connected corporation that is engaged in an active business will not be included in the calculation so long as certain conditions are met.

This proposal is in direct contradiction of the Minister of Finances' previous announcement that existing passive investments would be grandfathered as they are not, and there is no allowance for one-time large realized gains from passive investments. In addition, as outlined, realized losses available for carry-over from other tax years will not be included for the purposes of the calculations.

This measure is applicable to tax years beginning after 2018.

Budget Impact on Payment of Dividends by a Corporation

The second measure contained in the budget regarding the accumulation of assets of a company relates to the allocation of dividends paid as between eligible and non-eligible. Currently the directors of a company can choose whether to accumulate income inside the company that is taxed at the lower rate, now 13.5% as described previously, or at the higher rate of 26.5%. A corporation can also accumulate income from passive investments, but, in general terms there is no tax deferral advantage for accumulating investment income inside a corporation, or put another way, the combined corporate income taxes in investment income are approximately 50% in Ontario.

The government has perceived that payment of a non-eligible dividend form the accumulation of corporate income taxed at the small business tax rate of 13.5% and receiving a "dividend refund" for "refundable dividend taxes" paid on investment income can be an abuse of the tax system. The budget proposes to track the refundable dividend taxes in two accounts.

The new account will be "eligible RDTOH" and will track refundable taxes paid on eligible portfolio dividends. Payment of any dividend, eligible or non-eligible, will entitle a corporation to a refund from its eligible RDTOH account. RDTOH stands for "refundable dividend tax on hand",

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The existing RDTOH account, which will be renamed non-eligible RDTOH, will track refundable taxes paid under Part I of the Income Tax Act on investment income as well as on non-eligible portfolio investments. Refunds of RDTOH from this account will only be available by paying a non-eligible dividend.

If a corporation receives a refund of RDTOH on payment of a dividend to a connected corporation, then the connected corporation will pay refundable dividend tax, as is already the case, but the payment of refundable dividend tax will be added to the eligible or non-eligible RDTOH account depending on which account the paying company received the refund from.

Upon payment of a non-eligible dividend, a private corporation will be required to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

The existing RDTOH account of a corporation will be allocated to the two new accounts based on the amount in the GRIP account where the company is a Canadian Controlled Private Corporation. 38 1/3% of the balance of the GRIP account will be allocated to the eligible RDTOH account and the remaining balance, if any, will be allocated to the non-eligible RDTOH account. For non-CCPC's, the entire balance of the RDTOH account will be allocated to the eligible RDTOH account.

These measures will also be applicable to tax years beginning after 2018.

Other Budget Proposals

There will be an "anti-avoidance rule" regarding the passive investment income rules described above where a short tax year is created to defer the application.

Eligibility for Class 43.2 tax support for clean energy generation and conservation equipment is extended to property acquired before 2025.

The Working Income Tax Benefit will be renamed the Canada Workers Benefit and will be enhanced to 26% of earned income in excess of $3,000 to a maximum benefit of $1,355 for single individuals and $2,335 for families. The benefit will be reduced by 12% of adjusted net income in excess of $12,820 for single individuals and $17,025 for families.

The availability of the medical expense tax credit is broadened for service dogs for persons with a severe mental impairment.

Technical rules related to RDSP's have been extended to the end of 2023 regarding who can be a plan holder in the absence of a legal representative.

There were slight tweaks to eligibility for the Canada Child Benefit.

There will be changes to the rules around Health and Welfare Trusts.

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Transfers of property by a charity to a municipality will be considered a qualifying expenditure for the purposes of the revocation tax on a charity, subject to the approval by the minister on a case by case basis where a suitable recipient in the charitable sector cannot be found.

The mineral exploration tax credit is to be extended to flow-through share agreements entered into on or before March 31, 2019.

Reporting requirements and penalties for trusts have also been extended.

There are a number of other measures related to complex and international transactions, GST, and other items that can be found on the Department of Finance Canada website at the following address https://www.budget.gc.ca/2018/docs/tm-mf/tax-measures-mesures-fiscales-2018-en.pdf.

To discuss the impact of these new rules on your corporation, or for tax planning and estate planning issues please contact your regular engagement partner, or a member of the tax group, Garth Howes, Derek Michell, Jim Frederick or Bill Luyks by phone or email.