2018 FEDERAL BUDGET — BUSINESS TAX CHANGES

The 2018-19 Federal Budget brought down on February 27, 2018 by Minister of Finance Bill Morneau included several measures affecting the taxation of businesses, both corporations and partnerships. Most of those measures represent a tightening of the tax net in specific circumstances, to address perceived tax loopholes, and are largely technical in nature.

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In his Budget Speech the Minister also indicated that the federal government would incur a deficit of $19.4 billion for the current fiscal year ending March 31, 2018. Budget forecasts call for that deficit to stand at $18.1 billion for 2018-19 and to decline to $17.5 billion for 2019-20.

Changes to taxation of small business income

Current tax rules provide that the first $500,000 of active business income of a Canadian-controlled private corporation (CCPC) is taxed at rates lower than both the general corporate tax rate and personal income tax rates. The policy intention behind such rules was to leave small CCPCs, which can have difficulty accessing additional capital, with more retained earnings which could be re-invested in the business.

In 2017, the federal government released proposals for changes to the tax rules governing small businesses, to address what it viewed as unfair tax deferral opportunities arising as the result of the use of those rules. The proposals made proved to be controversial, and were subsequently amended. The Budget Papers set out the changes to the rules which will be phased in over the 2018 and 2019 taxation years.

The first such change is a reduction in the small business tax rate, from 10.5 percent to 10.0 percent, effective as of January 1, 2018. A further rate reduction, to 9.0 percent, will take effect as of January 1, 2019. There is no change to the small business limit, which remains at $500,000.

The second change will, however, reduce the business limit for corporations that have significant income from passive investments. Specifically, such limit will be reduced, on a straight-line basis, for CCPCs which have investment income between $50,000 and $150,000 in a year. The business limit of a CCPC is eliminated where its investment income for the year exceeds $150,000.

For the purpose of determining the reduction of the business limit of a CCPC, the Budget introduces the concept of adjusted aggregate investment income, or AAII.

A chart is included in the Budget Papers showing how a CCPC's business limit is reduced based on the amount of business and investment income earned in a particular year, and that chart can be found at https://www.budget.gc.ca/2018/docs/tm-mf/tax-measures-mesures-fiscales-2018-en.pdf.

The new rules on the reduction of a CCPC's small business limit will apply to taxation years beginning after 2018.

Changes to rules on refundability of taxes on investment income

Under current tax rules, passive investment income retained by a corporation is taxed at approximately the top personal income tax rate. Such taxes are added to the company's refundable dividend tax on hand, or RDTOH account. When such income is paid out to shareholders in the form of dividends, the corporation can claim a refund of such taxes paid at a rate of $38.33 for every $100 of taxable dividends paid to shareholders.

Dividends received by shareholders are generally characterized as being eligible dividends or non-eligible dividends. The former are presumed to have been paid out of corporate income that was subject to the (higher) general corporate tax rate and receive preferential tax treatment in the hands of the shareholder. Current rules provide that investment income earned by private corporations must generally be paid out as non-eligible dividends. Nonetheless, corporations are able, under the current system, to obtain a refund of taxes paid on investment income (as reflected in the company's RDTOH account), regardless of whether dividends paid are eligible or non-eligible. The Budget proposals seek to eliminate this advantage.

The rules respecting such refunds will be tightened to ensure that a refund of RDTOH will be available only where dividends paid out to shareholders by a private company are non-eligible dividends.

Extension of enhanced CCA treatment for clean energy assets

A tax deduction can be claimed by taxpayers for a portion of the cost of eligible assets, through the capital cost allowance system. That system allocates types of assets to different classes and prescribes the rate of depreciation which can be claimed for each class.

Under that CCA system, accelerated capital cost allowance rates are provided for assets which are included in Classes 43.1 (30 percent) and 43.2 (50 percent). Such assets are generally specified clean energy generation and conservation equipment.

Class 43.2 is currently available for qualifying assets which are acquired before 2020. The Budget proposes to extend eligibility for that class for five years, such that it will be available in respect of property acquired before 2025.

Changes to tax rules governing dividend rental arrangements

General tax rules provide that a corporation can claim a deduction for a dividend received from another corporation. There are exceptions to that rule, and one of those exceptions denies the deduction where the main reason for an arrangement is to allow the recipient to receive a dividend, while the actual risk of loss or opportunity for profit on the underlying share accrues to someone other than the dividend recipient. Such transactions are generally referred to a dividend rental arrangements.

In the federal government's view, some taxpayers and financial institutions had, through the use of equity derivatives, created sophisticated financial arrangements intended to circumvent the dividend rental arrangement rules. Amendments to those rules were introduced as part of the 2015 Federal Budget to address and target such arrangements, but the government's view is that some taxpayers are continuing to engage in what it views as abusive arrangements.

While such transactions can be challenged on an individual basis, the government has determined that the preferable approach is to introduce specific legislation to address the problem. This year's Budget includes two proposed changes in that regard. The first aspect of those changes will restrict the circumstances in which an investor can claim a specific exception to the 2015 rules (the "no tax-indifferent investor exception"), and the second will broaden the definition of the term "securities lending arrangement", to prevent such arrangements from being used to circumvent the 2015 rules.

The new rules will generally apply to dividends which are paid or became payable on or after February 27, 2018.

New anti-avoidance rules for certain share repurchase transactions

The corporate deduction for dividends received from another corporation can also be claimed where such dividends are "notional", meaning that they are deemed by the tax rules to arise is certain situations. One of the situations in which a deemed dividend (and the related deduction) can arise is on a repurchase of a share. The inter-corporate dividend deduction is intended to limit the imposition of multiple levels of corporate taxation on earnings distributed from one corporation to another.

Anti-avoidance provisions, in the form of dividend stop-loss rules, exist to prevent abuse of the intercorporate dividend deduction mechanism. In particular, rules were introduced as part of the 2011 Federal Budget to limit the deduction in certain circumstances involving shares held as mark-to-market property. In the view of the tax authorities, however, transaction structures have since been utilized which permit Canadian financial institutions to realize unintended tax benefits in the form of artificial tax losses on share repurchases.

To address that, the Budget proposes new provisions which will apply to shares held as mark-to-market property. Under those new rules, a tax loss otherwise realized on a share re-purchase will be decreased by any divided which is deemed to be received on that re-purchase and is eligible for the inter-corporate dividend deduction. The new rules will be effective with respect to share repurchases that take place on or after February 27, 2018.

Changes to rules at-risk rules for limited partnerships

Income or loss of a partnership for tax purposes is allocated to the partners of the partnership, and then included in the income of each partner. However, limited partners of a partnership are entitled to deduct their share of partnership losses only to the extent of what is termed their "at-risk amount" in relation to that partnership. Generally, any limited partner's at-risk amount is the amount of that partner's invested capital that is at risk in the partnership, together with any unpaid income allocated to them by the partnership.

Since they were introduced, the rules governing the tax treatment of partnership losses by a limited partner have been administered by the Canada Revenue Agency (CRA) on the basis that their application extends to cases in which the limited partner holding a limited partnership interest is itself a partnership. Such structures are generally identified as tiered partnerships.

A recent Court decision has had the effect of limiting the application of the at-risk rules in relation to tiered partnership structures. To clarify those rules, and to ensure that they will continue to apply to such tiered partnership structures, new rules will be put in place, together with a number of consequential amendments. While the new rules will generally apply with respect to taxation years ending on or after February 27, 2018, those rules will also limit the carryforward of affected losses which were incurred in taxation years ending prior to February 27.

Enhancements to CRA's administrative powers

The *Income Tax Act* provides the CRA to issue Requests for Information, or RFIs. A taxpayer who receives such an RFI is required to provide any requested information or documents for any purpose related to the administration or enforcement of the *Income Tax Act*, or certain international agreements. Where the taxpayer does not comply, wholly or in part with the RFI, the CRA can seek and obtain a Court order requiring that taxpayer to provide the requested information or documents.

The CRA is entitled to reassess any taxpayer within a fixed period (generally three or four years) following the Agency's initial assessment of the taxpayer for a particular tax year, after which the tax year may become statute-barred.

Where the taxpayer contests an RFI issued by the CRA, the period during which the CRA may reassess that taxpayer is effectively shortened and, in the government's view, that hampers the ability of the CRA to reassess in a timely fashion and on the basis of complete information.

To address that problem, the Budget proposes to introduce a new rule which will, in effect, stop the clock running with respect to the allowable reassessment period where an RFI becomes the subject of Court proceedings. Specifically, the new rule will provide that the reassessment period of a taxpayer is extended by the period of time during which the requirement or compliance order is contested. The extension period will start, in the case of an RFI, at the time the taxpayer seeks Court review of that RFI and, in the case of a compliance order, when the taxpayer opposes the CRA's application for such an order. In both cases, the period will stop at the time of final disposition (including any appeals) of the Court proceedings.

The Budget proposal will apply with respect to any proceedings begun after the new measure receives Royal Assent.

More detailed information on these and other Budget changes can be found in the 2018 Federal Budget papers, which are available on the Finance Canada website at https://www.budget.gc.ca/2018/home-accueil-en.html.