The 2018 Federal Budget and the Passive Investment Proposal Climbdown

Kim G C Moody FCPA, FCA, TEP
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Budget 2018 Q&A with Kim Moody

On February 27, 2018, the federal government released its annual "budget." This summary focuses only on the tax measures as it relates to private clients and our related commentary. With the exception of the passive investment proposals as described below, this year's budget was not all that "meaty." For the non-technically inclined person, please only read our executive summary. For the technically inclined, enjoy!

A. Executive Summary

1. Passive Investment Income Taxation

The government has completely backed away from its July 18, 2017 approach/proposal on how the taxation of passive investment income for Canadian-controlled private corporations ("CCPCs") would be taxed. The punitive tax rates/regime that were proposed have been fully eliminated with the integration principle being maintained. Instead, the government proposes to further restrict access to the small business deduction ("SBD") if the passive income of the corporation exceeds $50,000. Further technical amendments are being proposed to refine how a corporation will receive refunds on the taxation of its investment income. Overall, these proposals are welcome compared to the original proposals.

2. US Tax Reform Response

The budget has no proposed measures to counteract any competitive risks for US tax reform that will surely challenge Canada. Disappointing.

3. New Trust Reporting Requirements

As signalled in Budget 2017 and consistent with many other countries around the world, the government will introduce new reporting requirements for certain trusts that will require disclosure of trustees, beneficiaries, settlors and protectors. Such reporting requirements will be applicable for the 2021 and subsequent taxation years.

4. "At-Risk" Rules for Partnerships – Amendments

In order to effectively overturn the Federal Court of Appeal decision in *Green*, Budget 2018 has introduced amendments to "clarify" that the at-risk rules apply in a tiered partnership situation.

5. Health and Welfare Trusts

Health and welfare trusts ("HWTs") will soon be required to transition to the existing Employee Life and Health Trust ("ELHT") regime. Transitional rules will be introduced—after consulting with stakeholders—for existing HWTs. In addition, the Canada Revenue Agency ("CRA") will no longer adhere to its administrative positions for HWTs established after February 27, 2018.

6. Reassessment Rule Amendments

The budget proposes to amend the Act to extend the normal reassessment period in certain cases and to introduce a domestic "stop-the-clock" rule—similar to the existing rule for foreign-based information requirements—during the period of time the requirement is in dispute.

7. Reporting Requirements for a Taxpayer's Foreign Affiliate

The T1134 filing deadline to report a taxpayer's foreign affiliate(s) will be reduced from the current 15 months after the end of the taxation year to six months after the taxation year. This new rule will apply for taxation years that begin after 2019.

B. Analysis

1. Passive Investment Taxation Changes

Well, it's been a hell of a ride since July 18, 2017. On that day, the Department of Finance released a "consultation paper" that discussed alternatives to the taxation of passive income earned by a CCPC. The alternatives were highly controversial and ultimately such proposals suggested deploying a "penalty tax" that could result in a 73-75% flow-through taxation rate on certain types of investment income. The October 18, 2017 press release by the Department of Finance attempted to quell some of the obvious concerns by proposing a *de minimis* $50,000 of income that would be excepted from the new regime. In addition, the Department announced that existing assets held by CCPCs would be grandfathered. The October 18, 2017 announcement left more questions than answers but the government promised details in the 2018 Budget.

Tax practitioners and private business owners have been very concerned that the implementation of this flawed policy would dramatically impact CCPCs' (and their shareholders) ability to accumulate assets for a variety of reasons. In addition, valid concerns were raised as to why public corporations and non-residents would not be subject to such a harmful new regime. Our firm wrote an extensive blog about such concerns that can be accessed here.

Well, today's budget appears to be a full-scale retreat by the government. Instead of following its approach as laid out in the July 18, 2017 and October 18, 2017 releases, the budget will instead propose two new measures to limit deferral "advantages" from holding passive assets in a CCPC.

The first measure—applicable for taxation years that begin after 2018—will restrict access to the SBD for CCPCs who earn more than $50K of passive investment income in a taxation year. The proposal would reduce the SBD by $5 for every $1 of investment income above the $50K threshold such that the SBD would be reduced to zero if a CCPC earns $150K of passive investment income. This new rule will be in addition to the existing rule for taxable capital whereby the business limit of a CCPC is reduced on a straight-line basis if it, or any associated corporations, has taxable capital employed in Canada between $10M-$15M.

For purposes of computing the $50K of investment income, the budget proposes to use existing rules in

the Income Tax Act (the "Act") with a number of adjustments. This new concept will be defined as "*adjusted aggregate investment income*" under subsection 125(7) of the Act. Simplified, the new concept requires you to start with existing aggregate investment income—as defined in subsection 129(4) of the Act—and adjust as follows:

1. reduce such amount by any taxable capital gains (and losses) to the extent they arise from the disposition of a property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC or for such taxable capital gains (and losses) that arise from the disposition of a share of another CCPC that is connected with the CCPC, where in general terms, all or substantially all of the FMV of the assets of the other CCPC is attributable directly or indirectly to assets that are used principally in an active business carried on primarily in Canada;
2. net capital loss carry-forwards will be excluded;
3. dividends from non-connected corporations will be added;
4. income from savings in a life insurance policy that is a non-exempt policy will be added to the extent that it is not otherwise already included in aggregate investment income; and
5. investment income that is "incidental" to the active business will not be included

The following two paragraphs from the budget materials lay out the context of this first new rule:

The proposal represents an important departure from the July approach. Importantly, the design does not directly affect taxes on passive investment income. Under this proposal, the tax applicable to investment income remains unchanged—refundable taxes and dividend tax rates will remain the same, unlike the July 2017 proposal. No existing savings will face any additional tax upon withdrawal, thereby maintaining the Government's commitment to protect the tax treatment of all past savings and investments.

The new approach will be much simpler to comply with, will not require the tracking of new and legacy pools of passive investments, and will target only private corporations with more than $50,000 in passive investment income per year…"

This first new rule is very welcome; and certainly a whole lot better than what the government was proposing last July. Accordingly, the government deserves credit for listening to the concerns of the business community. However, this new rule will further restrict access to the SBD. Along with the 2016 SBD amendments that significantly restricted access (along with mind-numbing complexity), we are now left with a SBD that is very difficult to access and compute. As we have written about before, it is likely time for the SBD to be eliminated from the Act. However, the politics behind such an elimination likely make this not possible in the short term.

Notwithstanding the commitment to the theory of integration, the second measure—applicable for taxation years that begin after 2018—amends the existing refundable tax regime for CCPCs: *"(t)o better align the refund of taxes paid on passive income with the payment of dividends sourced from passive income, Budget 2018 proposes that a refund of RDTOH be available only in cases where a private corporation pays non-eligible dividends."*

An exception will be provided in respect of refundable amounts— "RDTOH"—that arises from eligible portfolio dividends received by a CCPC. In such cases, eligible dividends will be eligible to be paid to

recover the RDTOH. This will be facilitated through a new account— "eligible RDTOH"— that will track refundable taxes paid under Part IV of the Act on eligible portfolio dividends. A new ordering rule will require a CCPC to obtain a refund from its non-eligible RDTOH before it obtains a refund from its eligible RDTOH. Finally, any Part IV tax paid by a corporation that receives a dividend from a connected corporation will be added to the RDTOH account that matches the RDTOH account from which the payor corporation obtained its refund.

With respect to this second amendment, these rules appear more "technical" so as to help the government achieve its objective of trying to ensure that the deferral between personal income tax rates and the CCPC SBD rates are minimized. While more accounts are now required to be tracked, the additional complexity appears minimal and therefore welcome.

Overall, it is a big relief that the July 18, 2017 proposals are not moving forward. While the above measures will still take a bite out of certain entrepreneurs' pockets, the original proposals would have been an all-out disaster. When compared to that, these proposals are better.

2. US Tax Reform Response?

The budget contains no measures to counter-act any competitive risks/challenges that US tax reform will cause for Canadians. This is very disappointing. Instead, the budget documents contain one sentence that states:

> "*Over the coming months, the Department of Finance will conduct detailed analysis of the U.S. federal tax reforms to assess any potential impacts on Canada.*"

Well, hopefully the department doesn't study too long. In our view, a swift response—such as reductions of personal tax rates so as to enable our country to better compete for labour—would have been a preferred response. There has been much written in the last couple of months about how Canadian competitiveness is at risk with US tax reform. Such risks are real including the flight of private capital to the US. We as a country need good leadership here. Our firm has written about US tax reform and can be accessed here.

3. New Trust Reporting Requirements

Consistent with many other countries around the world and as signalled in Budget 2017, the budget proposes to introduce new beneficial ownership disclosure requirements—applicable for returns required to be filed for the 2021 and subsequent taxation years—for certain "express trusts" that are resident in Canada and to non-resident trusts that are currently required to file a T3 income tax return. "Express trusts" are defined in the budget documents as a trust created with the settlor's express intent—usually made in writing. Certain trusts will be exempt from the new reporting requirements and will include:

1. mutual fund trusts, segregated funds and master trusts;
2. registered plans;

3. lawyers' trust accounts;
4. graduated rate estates and qualified disability trusts;
5. trusts that qualify as non-profit organizations or registered charities; and
6. trusts that have been in existence for less than three months or that hold less than $50K in assets throughout the taxation year (provided that such assets are confined to deposits, government debt obligations and listed securities)

The new reporting requirements will include the identity of all trustees, beneficiaries, and settlors as well as the identity of each person who has the ability to exert control over trustee decisions regarding apportionment of income or capital of the trust (for example, a "protector").

A new penalty regime will be introduced for failure to file a T3 return—including the required beneficial ownership schedule—that will be equal to $25/day of delinquency with a minimum $100 penalty and a maximum of $2,500.

Overall, such new reporting requirements are not surprising given the push around the world to disclose beneficial ownership information for trusts and corporations. In the private realm, most private trusts are so-called discretionary trusts whereby the trustees have full discretion regarding income and capital allocations to the respective beneficiaries. In such a situation, how will the discretionary beneficiaries be disclosed?

In informal discussions with the Department of Finance, it appears that the new required form—to be released at a later date—will likely enable classes of beneficiaries to be reported as opposed to specific people. This makes sense but obviously, the devil will be in the details. Stay tuned.

4. Amendments to the Partnership At-Risk Rules

The existing "at-risk" rules in section 96 of the Act try to prevent the deductibility of limited partnership losses to the amount of the limited partner's "at-risk" amount. Overly simplified, the "at-risk" amount is the amount of investment that the limited partner has in the partnership (after considering the original investment, income/losses allocated to the limited partner and withdrawals/contributions).

In addition, there are a number of technical rules, including anti-avoidance rules, that are in place to try to prevent the artificial inflation of at-risk amounts. If losses of a partnership are allocated to a limited partner that is in excess of their at-risk amount in respect of the partnership, such losses become "limited partnership losses" which are generally not deductible. However, such limited partnership losses can be carried forward indefinitely and deducted to the extent that the limited partner's at-risk amount has increased.

A recent Federal Court of Appeal decision – *Green* – caught the attention of the Department of Finance. The decision found that the at-risk rules did not apply in the context of a tiered partnership (partnership owns an interest in another partnership). Budget 2018 will effectively reverse the *Green* decision so as to "*clarify that the at-risk rules apply to a partnership that is itself a limited partner of another partnership. This measure, along with a number of consequential changes, will ensure that the at-risk rules apply appropriately at each level of a tiered partnership structure.*"

This new measure will apply in respect of taxation years that end on or after February 27, 2018.

To be honest, our firm was a bit surprised by the *Green* decision given its very generous interpretation of the at-risk rules as it applied in a tiered partnership situation. It was fun while it lasted but the avoidance

of the at-risk rules in tiered partnership situation is now done.

5. Health and Welfare Trusts

For decades, the government has recognized HWTs as trusts established by an employer for the purpose of providing health and welfare benefits to its employees notwithstanding the Act does not explicitly define such vehicles. In many cases, such trusts have been utilized to provide employee benefits while relying on the non-taxability of such benefits to the employee further to the provisions of subparagraph 6(1)(a)(i) of the Act. The CRA has provided administrative guidance on HWTs over the years with some of the administrative positions being questionable (such as how surplus of HWTs was to be dealt with in certain situations).

In 2010, the government introduced the new Employee Life and Health Trust ("ELHT") rules into the Act that were similar but not identical to HWTs. Budget 2018 will now require existing HWTs to transition to the ELHT regime. However, the budget did not introduce transitional rules to enable HWTs to transition to ELHT since the government is seeking input from stakeholders on how the new rules should accommodate such transition and requests input no later than June 29, 2018. In addition, the CRA will not apply its administrative positions with respect to HWTs established after February 27, 2018.

Overall, our firm believes this is a welcome change. The old HWT administrative regime was subject to much abuse with little statutory guidance. Combining an old administrative regime with a statutory vehicle should help to clarify many issues that are currently not consistent between HWTs and ELHTs.

6. Reassessment Period Amendments

In most cases, the CRA has three or four years after its initial assessment in which to audit and reassess the taxpayer's tax liability and is generally "statute barred" from reassessing beyond that period (this is generally known as the "normal reassessment period"). In addition, there are existing rules which extend the normal reassessment period by three additional years in respect of assessments made as a consequence of a transaction involving a taxpayer and a non-resident with whom the taxpayer does not deal at arm's length. The budget proposes to ensure that the three-year extended reassessment period applies in respect of income arising in connection with a foreign affiliate of a taxpayer.

In addition, the government proposes to add an additional rule to provide the CRA with an additional three years to reassess a prior taxation year of a taxpayer, to the extent the reassessment relates to the adjustment of a loss carry-back where: a reassessment of a taxation year is made as a consequence of a transaction involving a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length; the reassessment reduces the taxpayer's loss for the taxation year that is available for carry-back; and all or any portion of that loss had in fact been carried back to the prior taxation year instituted after the new provision receives Royal Assent.

Finally, the Budget proposes to introduce a "stop-the-clock" rule for all information requirements orders—similar to an existing rule that applies when the CRA issues a requirement for foreign-based information and that information is then challenged in court. The existing rule for foreign-based information challenges "stops the clock" that extends the period in question open for reassessment by the amount of time during which the requirement is contested. This new measure will apply in respect of challenges.

7. Reporting Requirements for a Taxpayer's Foreign Affiliate

Currently, subsection 233.4(4) of the Act requires a taxpayer to file prescribed form T1134 in respect of each foreign affiliate of the taxpayer within 15 months after the end of the taxpayer's taxation year. The budget proposes to bring the filing requirement for any T1134 to be concurrent with the taxpayer's normal filing deadline; six months after the end of the taxpayer's taxation year. This new measure will apply to taxation years of a taxpayer that begin after 2019.

8. Increased Funding to Canada's Federal Courts

The budget announced that it will provide $41.9M over five years to "ensure that Canada's federal courts, including the Tax Court of Canada, receive adequate support." While our firm are not costing experts, it appears to us that this amount of financial injection is very low. Our tax court system and the court system in general are clogged with cases often taking years to settle. Our firm listened to the pleas of the Chief Justice of the Tax Court of Canada at the November 2017 Canadian Tax Foundation National Conference in Toronto for funding so as to hire more personnel and improve technology. It is very disappointing to see no action to the pleas of the Chief Justice.