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2018 Federal Budget – What business owners need to know

Yesterday, the Minister of Finance, Bill Morneau, presented his third Budget to the House of Commons. This was one of the most anticipated federal budgets, as many business owners have been frustrated with the government's proposals which began in July 2017. The initial proposal included eliminating income sprinkling amongst family members, increased taxation on passive income and converting of regular income into capital gains. The consultations resulted in over 21,000 emails to the government; a sign of strong displeasure over changes that primarily impact business owners and professionals.

Previously, the Federal and Ontario provincial government introduced changes to the corporate tax rates. Federally, the small business tax rate was reduced to 10% on January 1, 2018 and is set to reduce to 9% on January 1, 2019. The Ontario Liberal government implemented a reduction of the provincial small business tax rate from 4.5% to 3.5% effective January 1, 2018. The combined small business tax rate in Ontario for 2018 is 13.5%.

No changes were introduced to personal tax rates.

The rumored increase to the capital gains inclusion rate did not occur. The capital gains inclusion rate remains at 50%.

Passive Income Earned by Private Corporations

The July 2017 private corporation tax proposals could have greatly increased the effective tax rate on passive income generated from retained earnings originally taxed at low corporate rates.

The 2018 Budget proposes a simpler and less punitive method that will be used to limit the benefit of reinvestment of low-taxed business income in passive investments. Associated corporate groups that earn investment income and also use the low-rate of tax on business income will be restricted on the amount of the $500,000 Small Business Limit available to them. Certain passive investment income in excess of $50,000 will gradually reduce the group's small business limit, grinding it to nil once passive income reaches $150,000. This limit will operate in parallel to the existing rules that grind the Small Business Limit for corporate groups with taxable capital exceeding $10,000,000, and will be based on passive income reported in the previous taxation year.

This new rule will apply to corporate years beginning after 2018.

Partitioning of Refundable Corporate Taxes into Eligible and Non-Eligible Pools

Private corporations currently pay federal tax on investment income at rates that generally parallel the highest personal tax rates. To limit the incidence of double-taxation much of this tax is refundable to the corporation when eligible or non-eligible taxable dividends are paid to individual shareholders.

The 2018 Budget proposes to partition a private corporation's refundable dividend tax account (RDTOH) into two pools. Eligible dividends paid will only trigger refunds of corporate tax to the

extent that high-rate corporate income generated the RDTOH in the first place. This will generally be portfolio dividends received on Canadian public company shares or certain eligible dividends received from other private corporations.

RDTOH generated on other passive corporate income will only be recoverable by paying non-eligible dividends, taxed at much higher personal rates than eligible dividends.

This new restriction on recovery of RDTOH will apply to corporate years beginning after 2018.

Tax on Split Income (TOSI)

Although not included in the 2018 Budget, taxpayers are reminded of proposed changes to income splitting that came into effect January 1, 2018. These new rules propose to have tax on split income (TOSI) apply to family members who do not provide meaningful contributions to a business. Unless family members meet specific "bright line tests", split income will be taxed at the highest personal marginal tax rate. These tests include:

- Business owner's spouses, provided the owner is aged 65 or over and meaningfully contributed to the business;
- adults aged 18 and over who have made a substantial labour contribution (generally an average of at least 20 hours per week) during the year or during any five previous years;
- adults aged 25 and over who own more than 10% of a corporation that does not substantially derive its income from the provision of services; and
- individuals receiving capital gains if the gains would not be taxed at the highest rate under existing rules.

In cases where none of the exclusions are met, there is a reasonability test to determine how much of the income is subject to TOSI.

What Else Do You Need To Know?

- Health and Welfare Trust – these trusts will be discontinued and will need to be converted into Employee Life and Health Trusts

- Clean Energy Generation Equipment – enhanced rate of capital cost allowance (CCA) extended to property acquired before 2025 (from 2020)

- Reporting Requirements for Trusts – beginning with returns filed for 2021, increased reporting requirements could create filing requirements that did not previously exist and new penalties could impose fines up to a maximum of $2,500 per year for non-compliance

- Foreign Affiliate Reporting (Form T1134) – for years that begin after 2019, the filing deadline to be shortened to six months (from 15 months) to align with the taxpayer's regular income tax filing deadline

- US Tax Reform – Unfortunately, the Budget did not contain any measures to combat the challenges that the US tax reform may cause Canadians. The Department of Finance will conduct a detailed analysis of the reforms in the future and assess potential impact on Canada.