What tax measures can we expect in the 2018 federal budget?

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Tax Alert

With the federal government's 2018 budget expected to be released early next week—on Tuesday February 27, 2018—there is plenty of speculation surrounding what we may expect to see in it. The government has already indicated that this budget will include further details related to its July 18, 2017 proposals outlined in its consultation paper, *Tax Planning Using Private Corporations*. More specifically, the government indicated that the new passive income rules, as well as the final legislation for income sprinkling will be included in this budget. Based on its pre-budget consultations, the government will also likely include investments in scientific research. One question that many are wondering is whether the budget will contain measures in response to the US tax reform.

Tax planning using private corporations

Income sprinkling

Income sprinkling involves shifting income that would typically be realized by an individual subject to higher tax rates, to family members subject to lower personal tax rates—or who do not earn taxable income at all.

To address income sprinkling, the government released draft legislation with the July 18, 2017 consultation paper. However, concerns were raised that these proposed measures were circular, too complex and broad, and resulted in unintended consequences to taxpayers. Therefore, on December 13, 2017, the government released revised draft legislation which was intended to better target the income to be captured and simplify the application of the rules by including bright line tests. The government also stated that these measures will be legislated as part of the 2018 budget process. It is not clear, however, whether the government intends to introduce additional changes or provide further clarity on the application of these proposed rules.

Passive income proposals

In addition to income sprinkling, the government also noted, in the July 18, 2017 consultation paper, its intention to address the perceived tax advantages that can be obtained through holding passive investments in a private corporation, as opposed to personally. Income earned inside a corporation is subject to lower tax rates compared to income earned personally; therefore, when a corporate owner uses earnings taxed at the lower corporate tax rates to fund passive investments held within the corporation, this can result in an advantage because the amount of after-tax income that can be invested passively within the corporation would be larger than if the after-tax income was earned personally. As a result, the government stated that it will be designing new rules to limit this tax deferral advantage.

The government stated that when introduced, the passive investment rules will only apply on a “go-forward” basis. As such, investments already made—including the future income earned from such investments—will be protected, as will the ability for businesses to save the funds needed for contingencies or future investments (e.g., for the purchase of equipment, hiring and training of staff or business expansion). The government also stated that a passive income threshold of $50,000 per year for future, go-forward investments (equivalent to $1 million in savings based on a nominal five percent rate of return) will be available to provide more flexibility for business owners to hold savings for multiple purposes, including savings that can later be used for personal benefits such as sick leave, parental leave, or retirement.

Although the government has said that the rules would apply on a "go-forward" basis, it has not indicated when the new rules will become effective, how the income earned on passive investments held prior to the effective date will be set apart from income earned on investments acquired after the legislation, or how the $50,000 threshold will be applied (i.e., whether businesses will have to share it across associated corporations).

The details of the passive income rules are expected to be released in the 2018 budget, including a technical description of how the passive investment income threshold will be applied.

Intergenerational transfers of businesses

In response to the submissions received in connection with the July 18, 2017 consultation paper, the government has stated that it will work with family businesses—including farming and fishing businesses—to make it less difficult to hand down their businesses to the next generation while simultaneously protecting the fairness of the tax system. The government may provide more details on this in the budget.

"Boutique" tax expenditures and credits

Over the last two years, various tax credits have been eliminated (e.g., the education and textbook tax credit, children's fitness and arts tax credit, and public transit tax credit) in an attempt to simplify the tax system and cut down on certain inefficient programs and federal tax expenditures.

We may see other tax credits (e.g. the age credit1) eliminated as part of this year's budget.

Response to US tax reform

The United States recently enacted the most comprehensive tax reform in more than 30 years. Some of the more significant changes include a reduction in the corporate tax rates, from 35 per cent to 21 percent starting in 2018, as well as the personal tax rates. Businesses will also be allowed to immediately expense the cost of qualified property acquired over the next five years. Given the potential impact these US tax changes could have on Canadian businesses, we may see some measures in the budget in response to them.

Last week, after Finance Minister Bill Morneau met with private sector economists in Toronto, he stated that the government "will carefully consider the US changes and the international situation to make sure that our economy is competitive". He did not comment, though, on whether tax cuts are expected. However, Prime Minister Justin Trudeau stated at the World Economic Forum in Davos, Switzerland last month that Canada will not be cutting taxes to compete with the US changes. Many are concerned that the lower corporate tax rate in the United States could encourage businesses to redirect some of their investments there and cause more damage to the Canadian economy than the possible termination of NAFTA.

Innovation and the SR&ED program

Mr. Morneau announced in the media that a "key element" in the budget will focus on science and how it can play a role in building a solid economic foundation over the long term. In December, Mr. Morneau and Science Minister Kirsty Duncan held a roundtable in Toronto as part of the government's pre-budget consultations. The policies are likely to be based on a report, the Naylor Report ("the Report"), led by former University of Toronto president David Naylor. One of the report's recommendations included a $485 million government investment, phased in over four years, for granting councils as well as for support for investigator-led research.

What does this mean to you and your business?

Although, there is no way to determine with certainty what types of changes the government will include, historically proposed measures often take effect on the date of the budget. As such, you should consider whether any steps should be undertaken to minimize any potential adverse tax consequences before that day. Please contact a Grant Thornton advisor if you would like to discuss these potential tax changes and the implications they could have on you and your business.

[1] According to a 2017 paper by The Macdonald-Laurier Institute, "The Public Purse and the Public Good A framework for reviewing federal tax expenditures, Sean Speer, February 2017", the age credit should be eliminated as we should not be subsidizing people because they are old but rather because they are poor; old age is no longer a proxy for poverty.