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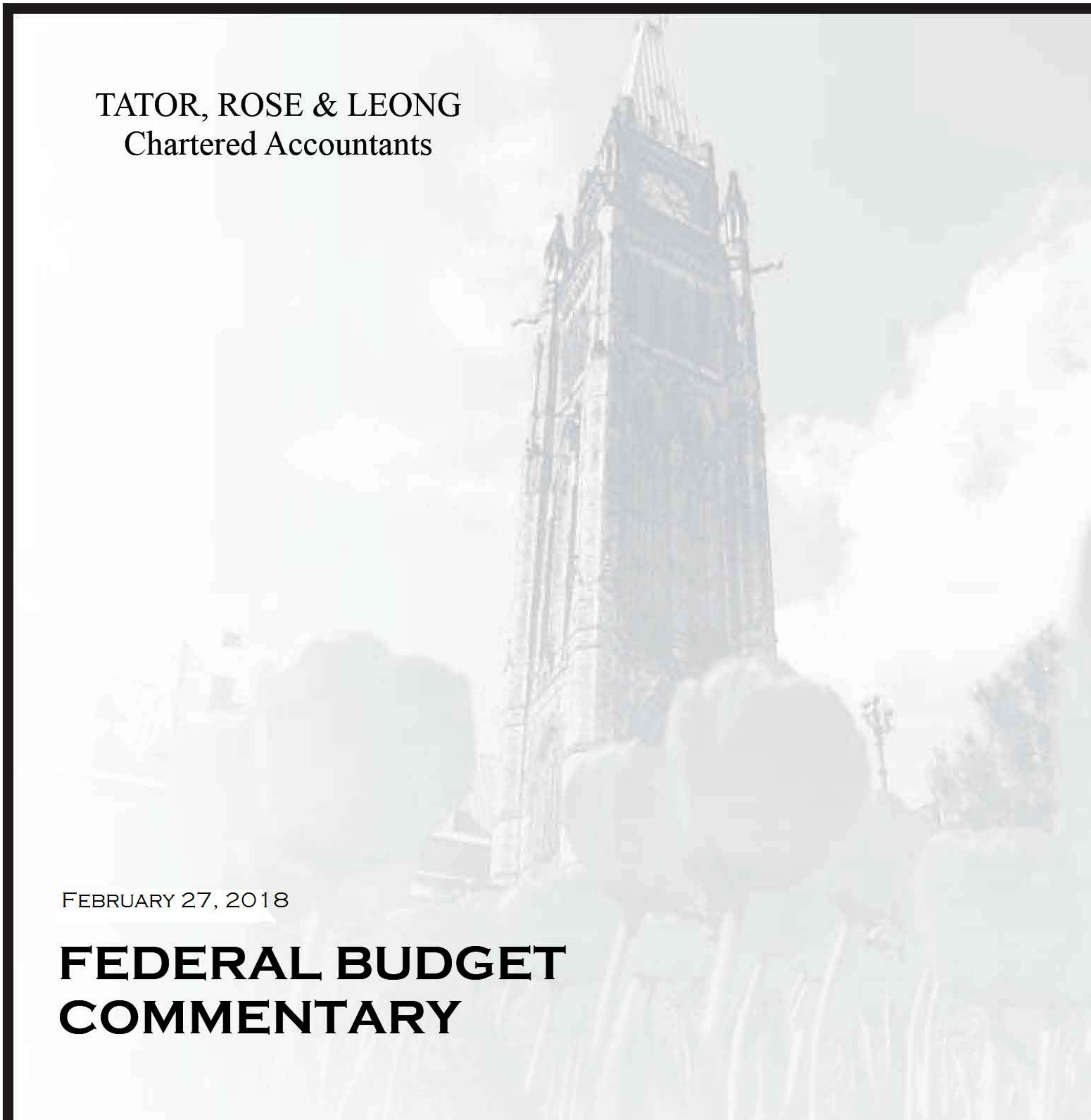

FEBRUARY 27, 2018

FEDERAL BUDGET COMMENTARY

2018

BUDGET COMMENTARY

Finance Minister Bill Morneau delivered the Liberal government's third budget on February 27, 2018 entitled "Budget 2018 – Equality + Growth: A Strong Middle Class". The budget forecasts a deficit of $19.4 billion for 2018, a $9.1 billion decrease from the $28.5 billion deficit projected a year ago, a $18.1 billion deficit for 2019 and a $17.5 billion deficit for 2020. The minister indicated the decrease in the deficit forecasts, compared to 2017's federal budget, can mainly be attributed to higher than anticipated corporate income tax revenues.

The minister indicated that "The Canadian economy is doing remarkably well. Over the past two years, hard working Canadians have created nearly 600,000 new jobs, most of them full-time positions. Unemployment rates are near the lowest levels we've seen in over 40 years". In addition, he indicated that "Canada leads all the other Group of Seven (G7) countries in economic growth".

Although the budget does not include any changes to the individual and corporate income tax rates or tax brackets, the budget confirmed the previously announced reductions to the corporate small business tax rate which were originally tabled in October 2017.

The 2018 budget includes a number of measures to support economic growth for specific industries and research programs, including $1.65 billion over three years in new financing for women entrepreneurs through the Business Development Bank of Canada and Export Development Canada. $115 million over five years as part of a Women's Entrepreneurs Strategy which includes a target that 15% of small to medium sized enterprises supplying the Government of Canada are firms owned by women. In addition, the budget proposes nearly $4 billion over the next five years to support the next generation of Canadian researchers.

As anticipated, the budget introduced a new tax regime for holding passive investments inside a Canadian Controlled Private Corporation. This new regime is part of the Liberal government's commitment to ensure the small business deduction is used by companies to reinvest in their active business, and not to reinvest in investment assets not related to the business activities. These new rules, which will be discussed in more detail on the following pages, will commence in taxation years starting after 2018.

Other budget measures announced, which will be discussed in more detail on the following pages, include:

- introduction of the new Canada Workers Benefit credit which will replace the Working Income Tax Benefit;
- eligible charitable donations to universities located outside of Canada;
- medical expenses relating to animals specially trained to perform tasks for patients with a severe mental impairment;

In closing, in contrast to the significant corporate tax changes which were first proposed in July 2017 relating to the new tax regime for holding passive investments in a corporation and the new income sprinkling rules this budget can be characterized as a stand-pat, cautious budget that does not contain any major surprises or significant changes in the government's economic or fiscal policies.

PERSONAL TAX CHANGES

Personal tax rates

There are no individual income tax rate or tax bracket changes proposed in this budget.

However, the budget does include the following changes to personal tax credits and other measures, as follows:

Canada Workers Benefit

The Working Income Tax Benefit, which is a refundable tax credit supplementing low-income workers, will be enhanced and renamed the Canada Workers Benefit. This benefit, which is intended to improve work incentive for low income Canadians, will be equal to 26% of each dollar of earned income in excess of $3,000 to a maximum benefit of $1,355 for single individuals without dependants and $2,335 for families.

The budget also proposes to improve access to the benefit by allowing the Canada Revenue Agency to determine if an individual is eligible to receive the benefit even if he or she does not claim it, and assess their return as if the benefit had been claimed.

This measure will apply to the 2019 and subsequent taxation year.

Donation to universities outside Canada

The budget proposes to allow individuals that donate to a university outside Canada to be eligible to claim a charitable donation tax credit, even where that university is not listed in the Income Tax Regulations.

This measure becomes effective February 27, 2018.

Medical Expense Tax Credit – Specialty animals

The budget proposes to expand the list of expenses eligible for the medial expense tax credit to include a variety of expenses relating to service animals specially trained to perform tasks for a patient with a severe mental impairment.

This measure will apply to eligible expenses incurred after 2017.

Registered Disability Savings Plan Holders

The budget proposes to extend the temporary measure that permits certain family members to be the plan holder of an RDSP for adults who might not be able to enter into contracts. The budget extends this measure (by five years) to the end of 2023. If a qualifying family member becomes a plan holder of an RDSP before the end of 2023, they can remain as the plan holder after 2023.

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PERSONAL TAX CHANGES (CONTINUED)

Child benefits

The budget proposes to amend the Income Tax Act to permit the federal government to share taxpayer information related to the Canada Child Benefit with the provinces and territories, beginning July 1, 2018. Access to the information is to be provided solely for the purpose of permitting the provinces and territories to administer their social assistance payment regimes.

BUSINESS TAX CHANGES

Corporate tax rates

There are no changes to the corporate income tax rates or to the $500,000 small-business income limit of a Canadian-controlled private corporation (CCPC). However, the budget re-confirms the measures which announced in October 2017 to lower the federal small business tax rate to 10% (from 10.5%), effective January 1, 2018, and to 9%, effective January 1, 2019.

The budget includes the following business tax proposals:

Passive Investment Changes

The budget proposes two measures (discussed in details below) to limit the deferral advantage of private companies earning passive investment income. These measures are applicable for taxation years beginning after 2018.

Small business deduction limit

The budget proposes to reduce the small business deduction limit for CCPCs (and associated corporations) that have income from passive investments in excess of $50,000. The budget reduces the small business deduction limit by $5 for every $1 of investment income in excess of $50,000. In other words, the entire small business deduction would be unavailable if income from passive investments of the associated group exceeds $150,000.

For purposes of determining the reduction of the business limit of a CCPC, the budget proposes that the investment income will be measured by a new concept referred to as “adjusted aggregate investment income” (AAII). Generally, the AAII will exclude taxable capital gains (and losses) from the sale of active investments and investment income that is incidental to the business.

Limiting access to refundable dividend tax on hand (RDTOH)

Currently, if the corporation has a balance in the General Rate Income Pool (GRIP) arising from income earned from a business (that was not eligible for the lower small business tax rate), the dividend paid to shareholders may be designated as eligible. A corporation can receive a RDTOH refund upon paying the eligible dividend. In these circumstances, the individual shareholder is subject to personal tax at a lower tax rate than if the dividend had not been designated as eligible dividend. Therefore, the total tax payable by the corporation and its individual shareholder on its investment income may be substantially lower than if the same income had been earned by the individual directly.

BUSINESS TAX CHANGES (CONTINUED)

The budget proposes to limit the tax advantages that can be obtained by CCPCs to access RDTOH refund on the distribution of an eligible dividend. The budget introduces a new RDTOH account, referred to as "eligible RDTOH" which will include dividends earned on portfolio dividends that were subject to refundable Part IV tax. The current RDTOH account will be redefined as "non-eligible RDTOH" and will track refundable Part I tax.

The proposed new system will allow a refund from the eligible RDTOH account on payment of an eligible dividend and a refund from the non-eligible RDTOH account on payment of a non-eligible dividend. Where a private corporation pays non-eligible dividends, it is required to obtain a refund from its non-eligible RDTOH account. If the non-eligible RDTOH pool is fully exhausted, a refund can then be obtained from its eligible RDTOH account. Eligible dividends can still be paid while the corporation has a non-eligible RDTOH pool but would not be able to obtain refund from the non-eligible RDTOH account.

Transitional rules will apply to permit the RDTOH refunds on eligible dividends to the extent of GRIP balance arising in taxation years that commence before 2019. For CCPCs the lesser of its existing RDTOH balance and 38 1/3 percent of its GRIP balance will be allocated to its eligible RDTOH account. Any remaining balance will be allocated to its non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

Income Sprinkling

The budget confirms that Finance will proceed with the income tax measures released on December 13, 2017 to address income sprinkling. The proposed measures will apply to the 2018 and subsequent taxation years. The general principal is that any adult family member that is inactive will pay the top rate of tax on split income (TOSI) which includes dividends from private company.

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