KPMG

TaxNewsFlash Canada

Federal Budget 2018 — What's Up?

February 14, 2018
No. 2018-04

Finance Minister Bill Morneau will deliver the Liberal government's 2018 federal budget on Tuesday, February 27, 2018. Although the government usually remains tight-lipped about the contents of the budget until it's released, there are indications about some of the measures that could be included. This year, the budget may be developed with consideration towards maintaining Canada's competitive position in light of recent U.S. tax reform changes, and could also include measures contemplated in a pre-budget report prepared by the House of Commons Standing Committee on Finance and presented to Parliament on December 8, 2017. This pre-budget report, along with other recent comments by Finance, may give some preliminary clues about what the federal budget has in store this year.

This year's pre-budget report again focuses on innovation, and contains recommendations related to research and development, tax credits, and capital cost allowance (CCA) rates. Though the government abandoned some of the private company tax changes it proposed in 2017, Finance has indicated that the budget will include details on its new passive income rules, as well as the final legislation for the tax on split income (TOSI) rules. On the international front, Finance may move forward with some of the OECD's Base Erosion and Profit Shifting (BEPS) initiatives.

Catch KPMG's same-day budget coverage
Whatever tax changes are announced in this year's budget, your KPMG adviser can help you understand their effect on your personal finances or business affairs, and point out ways to ease their impact or recognize new opportunities. You can now register for our budget highlights webcast planned for late afternoon on budget day. You can also

get highlights from our special budget edition of *TaxNewsFlash-Canada* — expected to be available on budget day from your KPMG adviser and on our website.

U.S. tax reform measures

It's not yet clear whether Canada intends to introduce new measures in response to the recent major U.S. tax reform changes, which were enacted on December 22, 2017 (see *TaxNewsFlash-Canada* 2018-68, "U.S. Enacts Tax Changes"). These U.S. changes reduced both the corporate and personal tax rates, and eased rules to allow businesses to immediately write off investments in certain capital assets, among other changes. In November 2017 at the 2017 Canadian Tax Foundation (CTF) Conference, Finance noted that it would decide on a response to any new U.S. tax reform legislation once it determined how it may affect Canada. However, more recently at the recent World Economic Forum in Davos, Switzerland, Prime Minister Trudeau reportedly said that Canada won't be cutting taxes to compete with the United States.

Private company tax changes

Passive income

While the government has cancelled its proposed private company changes to effectively limit access to the lifetime capital gains exemption (LCGE) and to prevent the conversion of income into capital gains, Finance has indicated it will proceed with changes to the rules on income sprinkling and passive investments. Specifically, Finance said it will release draft legislation related to the new passive investment income regime in the 2018 federal budget.

In a previous announcement, Finance stipulated that there will be no tax increase on passive investment income below a $50,000 annual threshold (see *TaxNewsFlash-Canada* 2017-47, "Private Companies — Passive Income Relief Announced"). Finance noted that it will maintain incentives to encourage venture capital and angel investors to invest in innovative companies. Although Finance has said that the new regime for passive investment would apply on a "go-forward" basis, it has not indicated when the new regime will take effect or how the new regime will be structured.

Finance has said it will consider how the new rules will affect capital gains, including whether capital gains realized on the sale of shares of a corporation engaged in an active business should be excluded in certain situations.

TOSI rules

As part of its proposed private company changes, Finance released draft legislation on income sprinkling in December 2017 (see *TaxNewsFlash-Canada* 2017-62, "Finance Provides Relief for Income Sprinkling Measures"). Finance said that these measures, known as the tax on split income (TOSI) rules, will be legislated as part of the 2018 federal budget. However, it's not yet clear whether Finance will introduce additional changes when the final rules are released as part of the budget

Finance's draft legislation simplified the income sprinkling rules to clarify the process for determining whether a family member makes contributions to a business, and thus is excluded from potentially being taxed at the highest marginal tax rate on amounts derived from the business. In addition, Finance introduced "bright line" tests that exclude certain specified individuals from the rules.

Intergenerational transfers

Finance previously said it is still considering how to make intergenerational transfers of small businesses, including farms, more efficient and less difficult (see *TaxNewsFlash-Canada* 2017-48, "Proposed Anti-Surplus Stripping Rules Dropped"). Previously, in its 2017 pre-budget report, the Committee recommended that Finance conduct an exhaustive review of inter-generational transfers. Although Finance proposed amending the rules for intergenerational transfers in 2017 as part of its private company tax changes, it ultimately did not move forward with any proposals at that time.

KPMG observations — Capital gains inclusion rate
It will be interesting to see if the upcoming budget includes any other measures to address the differential between the effective tax rate applicable to capital gains compared to dividends. Currently, the tax benefit of receiving capital gains treatment versus eligible dividends ranges from a high of almost 17% to approximately 6%, depending on your province of residence. In previous years, there has been media speculation about changes to the capital gains inclusion rate, which may resurface again for 2018.

Business tax changes

Innovation and patents

The media is reporting that the 2018 federal budget is expected to include significant funding for basic scientific research to support R&D activities in Canada. Recently, a report by an independent panel looking at then role of university research (the Naylor Report) calls on the government to gradually boost its funding for granting councils by $485 million a year.

As with last year's report, the Committee again recommends in its pre-budget report that Finance create a first patent program to subsidize the expenses incurred by small and medium-sized businesses obtaining a first patent. In the Committee's view, this program should be similar to a recent program launched in Quebec.

KPMG observations — Quebec patent box legislation
Quebec introduced patent box legislation to support innovation in Quebec's manufacturing sector in its 2016 provincial budget. The new tax measure, the first of its kind in Canada, provides a deduction to a qualifying innovative manufacturing corporation, for a taxation year equal to a portion of the value of a qualified patented feature that is integrated into qualified property that it sells or rents for the year. The legislation is intended to encourage companies to develop the results of R&D work carried out in Quebec that led to the granting of a patent.

Tax depreciation

The Committee's pre-budget report recommends that Finance consider making permanent the 10-year extension of the accelerated CCA rates for manufacturing and processing sectors. In addition, the Committee says that Finance should broaden the coverage of eligible capital assets.

The Committee also recommends that Finance introduce accelerated CCA rates in the 2018 federal budget for investments in oil and gas technologies that improve the environmental performance and efficiency in Canada's oil and gas sector.

Tax expenditures

Finance may look to the findings of its last tax-based expenditure review for 2017 when drafting the 2018 federal budget. Although the government has not publicly announced the results of its review of personal and corporate tax expenditures, Finance made some changes in the 2017 federal budget to eliminate certain personal tax credits and deductions such as the public transit tax credit and the home relocation loan deduction. Despite being among the most expensive tax expenditures, pension plans and RRSPs are probably unlikely to be targeted. However, it is possible that other deductions might attract special attention this year. As determined by the report, some other high-cost tax expenditures affecting individual taxpayers range from the 50% capital gains inclusion rate to the Canada employment tax credit.

In a business context, Finance could also scrutinize certain costly expenditures such as:

- Non-capital loss carryovers
- Partial inclusion of capital gains
- Non-refundable SR&ED tax credits
- Refundable SR&ED tax credits for CCPCs.

Other possible tax changes

Finance has indicated that it is exploring options for enhanced trust reporting requirements. At the 2017 CTF Conference, Finance said it hoped to provide an update in the 2018 federal budget.

The Committee's pre-budget report also recommends additional business and personal tax measures, including:

- Creating an investor tax credit to encourage investment in Canada's small and medium-sized businesses
- Renewing the Mineral Exploration Tax Credit for three years
- A comprehensive review of Canada's tax system, following the Committee report's acknowledgment that certain groups have advocated for such a review
- Recognizing income earned by campgrounds and storage facilities as active business income.
- Classifying mental health counselling and psychotherapy services as zero-rated supplies for the purpose of the GST and the federal portion of the HST
- Introducing a home energy retrofit renovation tax credit.

International tax changes

BEPS

The 2018 federal budget may further address issues related to the OECD's Base Erosion and Profit Shifting (BEPS) project. Last year, at the 2017 CTF Conference, Finance said that it is continuing to work on BEPS, and in particular focusing on the tax challenges of the digital economy, transfer pricing, attribution of profit, and monitoring and compliance with minimum standards. Finance also said it is reviewing whether it will adopt any additional provisions of the Multilateral Instrument (MLI) that it signed in June 2017 (see *TaxNewsFlash-Canada* 2018-33, "Canada Signs on for BEPS Treaty Changes").

Trade agreements

The Committee's pre-budget report recommends the government pursue bilateral, regional and multilateral trade agreements that address non-tariff trade barriers, ensure access to new markets for Canadian agricultural products, and ensure science-based regulatory standards. The Committee also recommends that the government build on the recently concluded Canadian Free Trade Agreement and continue to reduce internal trade barriers among provinces and territories.

KPMG observations

Although North American Free Trade Agreement (NAFTA) negotiations are still ongoing, the budget could include measures to address Canada's international trade situation.

Complete tax-sensitive transactions before budget day

As with any budget, there's no telling what types of changes the government may have in store this year. Since federal budgets often propose measures that take effect on budget day, your best defense against adverse tax changes is to complete or close all tax-sensitive transactions before budget day, if it makes sense from an investment and business perspective.
