GALLOWAY BOTTESELLE & COMPANY

Chartered Professional Accountants

ISSUE **74**

The Abacus

PROFESSIONAL **STRENGTH** PERSONAL **SERVICE** PRACTICAL **SOLUTIONS**

2018 Liberal federal budget

The federal government released its 2018 federal budget on 27 February 2018. Although this article does not address every aspect of the budget, there are several items that we wish to bring to your attention.

Passive investments

ONE OF THE LIBERALS' PROMISES in 2017 was to change how passive investment income was taxed. Fortunately, the changes that have now been proposed are not as drastic as they had originally suggested in July 2017. Currently, for a Canadian controlled private corporation ("CCPC"), the first $500,000 of active income receives a preferential tax treatment, and the small business deduction ("SBD") reduces the tax rate to 10-18%, depending on the province. For income above $500,000, the corporation is subject to tax at the general rate of 27-31%, again depending on the province.

The budget proposes to reduce the $500,000 small business deduction for CCPCs (and associated corporations) if they have passive income in excess of $50,000. The budget will reduce the small business deduction by $5 for every $1 of investment income earned above the $50,000 threshold. At $150,000 of investment income, the CCPC (and associated corporations) will no longer have any SBD. Although this will increase the corporate taxes payable, a deferral of 21-27% still exists compared to the top marginal personal rate. Dividends paid from earnings taxed at the higher rate will qualify as eligible dividends which are taxed at a lower tax rate personally. Consequently, the total taxes paid corporately and personally will not be higher than the current levels (subject to changes in tax rates) once dividends are paid from the company under the new rules. **The rules will apply to taxation years beginning after 2018.**

SEE **FEDERAL BUDGET** P. 2

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FEDERAL BUDGET CONT'D FROM P. 1

Two examples of how the new rules on passive investments could affect your taxes

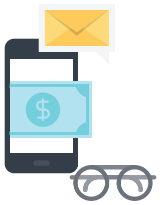
1

IF YOU LEAVE more than $500,000 of earnings in your corporation, and have investment income in excess of $150,000, you will lose the full $500,000 SBD. This will increase your corporate taxes anywhere from $62,000 to $90,000 depending on your province of residence. However, as mentioned, when you distribute these earnings as dividends your personal taxes will be reduced by approximately the same amount.

2

IF YOU LEAVE $300,000 of earnings in your corporation, then you are not using $200,000 of the SBD. Under this scenario your corporation can have investment income of $90,000 before your corporate taxes will be affected.

Refundable tax



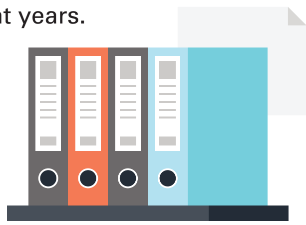
When a CCPC earns passive income, a portion of the taxes paid by the CCPC is refundable when dividends are paid to the shareholders. Currently, a CCPC will receive the refund when it pays either eligible or non-eligible dividends. The eligible dividends are taxed at a lower rate personally and, as such, usually works in the taxpayer's favour. The budget proposes to restrict the ability of a CCPC to receive a dividend refund when eligible dividends are paid.

Health and welfare trusts

The budget proposes that any current health and welfare trusts be converted to Employee Life and Health Trusts by 2020. As of publication of this issue, the government had not released any details of the new trusts.

Reporting requirements for trusts

The budget proposes to require trusts to provide additional information on an annual basis. Information such as the identity of all trustees, beneficiaries and settlors will need to be disclosed for trusts filed for 2021 and subsequent years. The budget also introduces new penalties for failure to file a T3 Trust return.



Foreign affiliate reporting

Form T1134 must be filed if you or your corporation has an investment in a controlled foreign affiliate. The budget proposes to shorten the filing deadline for Form T1134 from 15 months, to six months. The change to the deadline will apply to taxation years that begin after 2019.

Tax on split income

No additional information was released on the tax on split income rules, and we anticipate that the rules as announced in December 2017 will proceed without additional changes. This means that, in most cases, if a professional corporation pays a dividend to spouse or family members, the dividend will be taxed at the highest tax bracket in the applicable province. These rates range from 48-54% depending on the province. ■

PRINCIPAL RESIDENCE EXEMPTION

IF YOU ARE a Canadian resident, you are normally eligible for the principal residence exemption—a provision of the *Income Tax Act*—if you have a gain on the sale of your home. Therefore, if the property was your principal residence for all years you owned it—or all years but one—the entire gain is exempt. (The exempt fraction of the gain cannot exceed 1/1, since at that point the full gain is exempt).

$$\text{Portion of gain exempt from tax} = \text{GAIN X}\left[1+\left\{\begin{array}{c}\text{Number of years}\\\text{you designate the property}\\\text{as your principal residence}\end{array}\right\}\Big/\left\{\begin{array}{c}\text{Number of years}\\\text{you owned}\\\text{the property}\end{array}\right\}\right]$$

The "**1+**" in the numerator allows for the fact that you can designate only one property per year as your principal residence. (Actually, your entire family—meaning you and your spouse and unmarried minor children—can designate only one property per year). Thus, if you sell a home and buy another one in the same year, you can designate only one home as your principal residence for that year. The "1+" makes sure that you don't lose your exemption on the other home in respect of that year.

Normally, you can designate the property as your principal residence in a year if you or your spouse or children "ordinarily inhabit" the property during the year. The courts and the CRA allow a low threshold to meet the "ordinarily inhabit" requirement. For example, if you stay in your cottage for a couple of weeks a year, that will normally meet the "ordinarily inhabit" requirement for the year. (Of course, if you designate the cottage for some years, you cannot have the principal residence exception apply to your city home for those years).

When you sell your principal residence, you must now report the sale on Schedule 3, *Capital Gains*, which is filed with your T1 tax return for the year of sale. (Before 2016, the CRA did not require reporting for the sale of a principal residence if it was your principal residence for every year that you owned it.) If the home was not your principal residence for all years of ownership, you must also file Form T2091, *Designation of a property as a principal residence by an individual.* ■

AROUND THE COURTS

ORTHODONTIST DENIED GST HST INPUT TAX CREDITS

Most businesses can claim a full **input tax credit** ("ITC") to recover all the GST/HST they pay on their expenses. That way, the real cost of the GST/HST is imposed only on consumers. However, businesses that make "exempt" supplies cannot claim ITCs, though they do not charge GST/HST on their services. Thus, the GST/HST is a real cost to such businesses. This includes physicians, dentists, and most other regulated healthcare providers.

The BACKGROUND | Orthodontists provide dental services, which are exempt, but they also sell braces, which are "zero-rated" as medical devices. No tax applies to a zero-rated supply, but the business is allowed to claim ITCs for its costs of making such sales. Since 1992, because orthodontists provide both exempt services *and* zero-rated goods, the CRA has an administrative policy allowing orthodontists to claim 35% of their ITCs.

The CASE | In the recent case of *Dr Brian Hurd Dentistry Professional Corp. v. The Queen*, the Tax Court of Canada held that this policy is wrong.

The RULING | The Court ruled that what an orthodontist provides is a "single supply": the dental services and braces cannot be separated, since neither can usefully be supplied without the other. Under the law developed by the Courts over the past 20 years, a single supply has only one status for GST/HST purposes: that of the dominant element. The Court found that the dominant element was the dental services. Thus, the orthodontist's sales were all exempt, and he was unable to claim any ITCs.

The IMPLICATIONS | This case will cause serious problems for orthodontists if the CRA decides to follow it and revise its administrative policy to disallow all ITCs. Since the decision was issued under the Tax Court's Informal Procedure, it is not a binding precedent, and the CRA may choose to ignore it; but given the Court's ruling, the CRA may feel that it should re-evaluate its policy to reach the correct legal result. ■

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