Budget 2018

Business owner’s executive briefing

March 8, 2018

The new federal budget includes several measures that target the cornerstone of the Canadian economy: small and medium sized enterprises (SMEs). How will the new budget affect you and your business?

The restrictions on income splitting introduced in 2017 and the new passive investment income rules from this year's budget legislation are the most significant developments that will put pressure on many businesses to make adjustments to their structure and operations. A reduction in the small business tax rate will provide some relief, while other changes may require close attention from you and your tax team.

A year of significant changes for SMEs

The Canadian business sector was anticipating a number of changes from the 2018 federal budget – some helpful, others a cause for concern. When the legislation was unveiled at the end of February, it did indeed outline significant changes that will impact the business community, though it was less substantive than anticipated and left important questions unanswered.

We've addressed the most significant developments, surprises and items to watch for in this executive briefing, to help you understand where you may need to take action to lead your enterprise through the transition to the new tax rules. For a more detailed and comprehensive overview of all the tax measures within this year's federal budget, please see our Budget 2018 report, which was prepared by a multidisciplinary team of Grant Thornton tax experts.

New measures seek to limit passive income

The government announced last July that its 2018 budget would seek to curtail the perceived tax advantages available to corporations that retain and invest in passive assets, though it did not provide any draft legislation at that time. The measures proposed in the budget were less complex and more targeted than had been anticipated, though they also fell short of at least one important pre-budget promise.

What you need to know about these changes, which will take effect in tax years that begin after 2018, is the following:

- The budget will limit access to the small business tax rate for SMEs (or associated companies) that have over $50,000 of passive income in a year;The government backtracked on its earlier pledge to grandfather passive assets and the income from those investments made before this year – there is no such protection in the legislation relative to the reduction in the availability of the small business tax rate; and
- Corporations will have new limits on recovering refundable taxes.

More details regarding the changes to passive income rules can be found here.

Perhaps the most important practical effect of these changes is the new cap on passive investment earnings within your corporation of $50,000 a year. Exceed the cap, and you will progressively and rapidly lose access to the small business tax rate for your company's active business income. Exceed $150,000 and the small business tax rate will be eliminated entirely.

Further, based on the government's earlier pledge that "all past investments and the income earned from those investments will be protected," business owners may have increased their passive investments inside their corporations last year – or missed an opportunity to begin a more measured restructuring.

Research conducted by Grant Thornton prior to the release of the budget found that the government had done an inadequate job of communicating its plans related to passive income to the SME community – one the Prime Minister referred to as the "heart of the economy." The specific measures proposed are likely to have taken many by surprise.

We know many SMEs use passive investments to survive cyclical downturns or to pay for strategic acquisitions, and some caution is required before making any substantial changes that would jeopardize these important business priorities.

Restrictions on income splitting

The government also proposed important changes to the way in which income distributed from Canadian businesses would be taxed. Initially put forward in July 2017, and modified in October of that year, these changes have significant implications for SMEs that distribute income to multiple individuals, including co-owners and family members.

The budget legislation did not contain any modifications or improvements beyond those released in October, and it failed to address a number of important questions raised by business owners and tax professionals in the meantime.

The key elements of these changes are:

- There are new limits on how business income can be distributed to those who do not have a substantial ownership stake (10% or more) or who have not contributed substantially to the enterprise;
- The most restrictive rules apply to professional businesses (i.e., lawyers, doctors and accountants), as well as those businesses that derive income from "services;" but
- The legislation leaves the definition of "services business" undefined, leaving a substantial grey area that maybe a source of confusion and uncertainty until it is resolved.

More details regarding the changes to income splitting rules can be found here.

Like passive investment income, income splitting is a tool that many ordinary Canadian businesses use to generate savings that supports future business growth. Some business owners feel that these changes to income splitting rules will limit their ability to expand and innovate. This may also push business owners to make short-term decisions with their capital that is driven by the nuances of tax policy – not what's in the long-term interest of their businesses or the Canadian economy.

There are exemptions to the new rules that apply under certain circumstances, though – as we noted above – there are also areas of continuing uncertainty. If your business distributes corporate income to multiple individuals, you should consider working with your qualified tax advisor to review these arrangements as soon as possible.

Small business tax rate to be lowered over two years

Plans to phase in a lower tax rate for small businesses were confirmed in the budget, one change that will provide a measure of welcome relief.

Essentially, these changes mean:

- The small business tax rate will be lowered to 10.5% in 2018, a decline of 0.5%; and
- The rate will shrink to 9.0%, effective January 1, 2019.

On its own, a rate reduction can have positive effects, boosting the competitiveness of Canadian companies in the international arena, and keeping more money within the communities where SMEs operate.

However, when considered in conjunction with other tax measures targeted at SMEs, these cuts may prove to be too small to offset the increased costs triggered by changes to passive income and income splitting rules. In fact, our research shows that two-thirds of business owners believe the net effect of all the proposed tax changes will be negative.

Cross-border measures target enforcement and compliance

The budget included measures to combat aggressive international tax avoidance using so-called "tracking arrangements" as well as tax-free distributions to non-residents. The government also indicated that it will continue to work with its international partners to improve international dispute resolution, and to ensure a coherent and consistent response to fight cross-border tax avoidance.

No NAFTA-specific measures in the budget

Although there were no provisions directly related to NAFTA in this year’s budget legislation, this is an issue that is front and centre for many Canadian businesses that have direct or indirect business relationships south of the border.

Continued uncertainty and a heightened degree of volatility persists in US trade policy circles, and it’s exceptionally difficult to predict how things will play out over the course 2018. The recently proposed tariffs around steel and aluminum could have a substantial impact on Canadian businesses, and manufacturers may need to look beyond the US to other international opportunities in order to diversify and protect future growth options.

Opportunities not taken

Despite speculation over the last couple of years, the government did not provide any specific measures related to the Scientific Research and Experimental Development (SRED) program in this budget. This may have been a missed opportunity to make innovation funding more easily accessible while also improving the competitiveness of Canadian businesses on the global stage.

Likewise, the budget did not include any measures in response to the sweeping changes the US has made to its corporate and personal tax regimes. Instead, the budget pledges that the government will review and analyze US federal tax reforms.

Helping you realize your potential

SMEs are very important to the Canadian economy, meaning that the policy changes incorporated in this budget can have far-ranging consequences.

As a business owner, you are a leader in your corporation and your community. Your objective may be seeking meaningful, effective tools for protecting your employees, growing your business, supporting your communities and effectively funding your own retirement.

Grant Thornton works with SMEs to manage challenges and realize opportunities – to help business owners navigate through these tax measures in this new environment.