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TaxNewsFlash Canada

# 2018 Federal Budget Highlights

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Finance Minister Bill Morneau delivered the government's 2018 federal budget on February 27, 2018. The budget expects a deficit of $19.4 billion for fiscal 2017-2018, and forecasts deficits of $18.1 billion for 2018-2019 and $17.5 billion for fiscal 2019-2020.

As expected, the budget introduces the new taxation regime for holding passive investments inside a private corporation, originally contemplated in July 2017. Under these proposals, if a corporation and its associated corporations earn more than $50,000 of passive investment income in a year, the amount of income eligible for the small business tax rate would be reduced, such that the business limit would be reduced to zero at $150,000 of investment income.

As in previous years, the budget focuses on tax-tightening measures. Specifically, the budget legislates that the at-risk rules apply to a partnership that is itself a limited partner of another partnership. The budget also proposes to tighten certain synthetic equity arrangements and securities lending arrangements, and expands the stop-loss rules on certain share repurchase transactions. In the area of international tax, the budget reduces the ability of non-resident shareholders to enter into transactions to extract Canadian corporate surplus in excess of the paid-up capital (PUC) of its shares. The budget also indicates that Finance will proceed with released draft legislative measures for the GST/HST for investment limited partnerships, with certain changes.

The budget does not include any changes to the personal or corporate tax rates, or any enhanced capital cost allowance in response to U.S. tax reform. However, Finance did reiterate that it intends to conduct a detailed analysis of the U.S. federal tax reforms to assess any potential impacts on Canada.

Although the budget provides a deduction for employee contributions to the enhanced QPP and requires certain trusts to file a T3 return to provide additional information, it did not include any changes to the capital gains inclusion rate or stock option deductions. Further, there were no measures related to changing the taxation of intergenerational family transfers. Finance reiterated that it will proceed with the tax on split income measures released on December 13, 2017 but did not include any changes in the budget.

As expected, the budget invests in innovation and skills training and also advances the business interests of women. The budget announced $2.6 billion in incremental support over five years for new innovation programs and new initiatives to make business regulations more efficient and less costly and also introducing a digital research infrastructure strategy. The budget targets $700 million to the industrial research assistance program and also makes investments in a new women's entrepreneurship strategy.

The tax highlights of the budget are as follows:

## Passive Investment Changes

The budget introduces a simplified approach to address the tax deferral advantages in accumulating surplus savings in a private corporation. These new amendments, which abandon the complexity of Finance's private company consultation paper released in July 2017, propose two new measures applicable for taxation years beginning after 2018 — a business limit reduction and a change to limit certain tax advantages that can be obtained by Canadian controlled private corporations (CCPCs) to access refundable taxes on the distribution of certain dividends. The new rules include certain anti-avoidance measures that may apply, for example, where certain transactions are entered into to avoid these measures, such as the creation of a short taxation year.

### *Business limit reduction*

The budget proposes to reduce the small business limit for CCPCs (and associated corporations) that have a certain threshold of income from passive investments. Specifically, the budget reduces the business limit on a straight line basis for CCPCs that have between $50,000 and $150,000 of investment income. The budget reduces the small business deduction by $5 for every $1 of investment income above the $50,000 threshold. In other words, the business limit would be nil at $150,000 of investment income.

Currently, there are rules in the *Income Tax Act* to reduce the small business limit where the corporation and its associated corporations have taxable capital employed in Canada between $10 million and $15 million. This business limit reduction will operate together with this new business limit reduction for taxable capital. The reduction in a corporation's business limit will be the greater of the reduction under these measures and the existing taxable capital reduction provisions.

*Adjusted aggregate investment income* — For purposes of determining the reduction of the business limit of a CCPC, the budget propose 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. These exclusions from AAII are intended to address the concerns regarding the encouragement of venture capital and angel investors in Canadian innovation.

### *Limiting access to refundable taxes*

The budget also proposes to limit certain tax advantages that can be obtained by CCPCs to access refundable taxes on the distribution of certain dividends. Under the current tax system, a corporation can receive a refundable dividend tax on hand (RDTOH) refund upon paying an eligible dividend. The budget proposes to allow a refund of RDTOH where a private corporation pays non-eligible dividends, unless the RDTOH arises from eligible portfolio dividends received by a corporation.

To address the refund of taxes associated with portfolio dividends, the budget introduces a new RDTOH account, referred to as "eligible RDTOH". This new account will track refundable taxes paid under Part IV of the *Income Tax Act.* The current RDTOH account will be redefined as "non-eligible RDTOH" and will track refundable taxes paid under Part I of the Act. Taxpayers will only be able to obtain refunds from this account upon the payment of non-eligible dividends. Where a private corporation pays non-eligible dividends, it is required to obtain a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.

*2019 Transitional RDTOH* — The budget proposes specific transitional rules for existing RDTOH balances. For CCPCs, the budget allocates the lesser of its existing RDTOH balance and 38 1/3% of the balance of the GRIP, if any, to the CCPC's non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

## Business Tax Changes

### *At-risk rules for tiered partnerships*

The budget clarifies how the at-risk rules apply to a limited partnership that is itself a limited partner of another partnership. In particular, for a limited partnership that is a member of another limited partnership, the lower-tier partnership losses that can be allocated to its partners will be restricted by the upper tier partnership's at-risk amount in respect of the lower-tier partnership. In addition, the budget proposes that limited partnership losses of a limited partner that is itself a limited partnership, will not be eligible for indefinite carry-forward. These losses will be reflected in the adjusted cost base of the partnership's interest in the lower-tier limited partnership.

The proposed amendment addresses a recent Federal Court of Appeal decision, which Finance says could result in limited partnership losses becoming deductible in situations

where, according to Finance, they would have been restricted under the long-standing understanding of the at-risk rules.

The proposed amendment will apply to taxation years that end on or after February 27, 2018, including in respect of losses incurred in taxation years that end prior to February 27, 2018. In particular, losses from a partnership incurred in a taxation year that ended prior to February 27, 2018 will not be available to be carried forward to a taxation year that ends on or after February 27, 2018 if the losses were allocated, for the year in which the losses were incurred, to a limited partner that is another partnership.

### *Artificial losses using equity-based financial arrangement*

The budget introduces legislation to clarify certain aspects of the synthetic equity arrangement rules and the securities lending arrangement rules to prevent taxpayers from realizing artificial tax losses through the use of equity-based financial arrangements.

*Synthetic equity arrangements* — The budget clarifies the no tax-indifferent investor exception to the synthetic equity arrangement rules. The budget proposes that the exception cannot be met when a tax-indifferent investor obtains all or substantially all of the risk of loss and opportunity for gain or profit in respect of the Canadian share, in any way. This includes where the tax-indifferent investor has not entered into a synthetic equity arrangement or a specified equity arrangement in respect of that share.

The proposed amendments will apply to dividends that are paid, or become payable, on or after February 27, 2018.

*Securities lending arrangements* — The budget broadens the definition of “securities lending arrangement” to ensure that taxpayers that enter into substantially similar arrangements are also subject to several provisions normally applicable to “securities lending arrangements”. As a result of the proposed amendment, when a taxpayer receives dividends on a Canadian share acquired under such a substantially similar arrangement, the dividend rental arrangement rules will generally apply. Accordingly, the inter-corporate dividend deduction will be denied, resulting in a dividend income inclusion that will offset the available deduction for the amount of the corresponding dividend compensation payments made to the counterparty under the arrangement.

The budget also clarifies the interaction of two rules governing the deductibility of dividend compensation payments made by a taxpayer under a securities lending arrangement. Under the first rule, a taxpayer that is a registered securities dealer is permitted to deduct up to two-thirds of a dividend rental compensation payment made to a counterparty. The second rule applies when a securities lending arrangement is a dividend rental arrangement, and permits the taxpayer (regardless of whether it is a registered securities dealer) to fully deduct any dividend compensation payment made to the counterparty. The budget clarifies that if the second rule applies, the first rule does not.

The proposed amendments will apply to dividend compensation payments that are made on or after February 27, 2018 unless the securities lending or repurchase arrangement was in place before February 27, 2018, in which case the amendments will apply to dividend compensation payments that are made after September 2018.

### *Dividend stop-loss rule on share repurchase transactions*

The budget amends the dividend stop-loss rule to decrease the tax loss on a repurchase of shares held by a taxpayer as mark-to-market property where it receives a tax deductible inter-corporate deemed dividend on the repurchase. Under the amended rule, the tax loss will generally be decreased by the full amount of the deemed dividend. This amendment is generally targeted at Canadian financial institutions seeking to realize a tax loss on a share repurchase that exceeds the mark-to-market income previously realized by the financial institution on the shares.

Although the current dividend stop-loss rule applies to shares held as mark-to market property where the corporate taxpayer is deemed to have received an inter-corporate tax-free dividend on a share repurchase, the tax loss reduction can be less than the amount of the deemed dividend as a result of the formula used to calculate the allowable loss in these circumstances. Generally, under the current rule, the dividend stop-loss rule only denies a portion of the tax loss realized on a share repurchase equal to the excess of the original cost of the shares over their paid-up capital. The portion of the tax loss equal to the mark-to-market income previously realized on the shares is allowed on the premise that the taxpayer already paid tax on that income. However, if that income was fully offset under a hedge, the taxpayer would realize an artificial tax loss on the share repurchase.

This proposed tax measure to decrease the tax loss on the repurchase of mark-to-market property will apply to share repurchases occurring on or after February 27, 2018.

### *Health and Welfare Trusts*

The budget proposes to discontinue the Health and Welfare Trust tax regime and facilitate the conversion of these trusts into Employee Life and Health Trusts through transitional rules.

Currently, the tax treatment of Health and Welfare Trusts is based on administrative positions published by the CRA since there are no legislative rules in the *Income Tax Act* that specifically apply to these trusts. The Act does, however, include rules that apply specifically to Employee Life and Health Trusts, another type of trust arrangement that also provides health benefits for employees. These legislative rules are very similar to the CRA's administrative positions for Health and Welfare Trusts. The budget proposes to have only one set of rules apply to these types of arrangements and, as a result, the CRA will no longer apply their administrative positions to existing Health and Welfare Trusts after 2020 or to Health and Welfare Trusts established after February 27, 2018. Trusts that do not

convert (or wind up) to an Employee Life and Health Trust will be subject to the normal trust income tax rules.

Finance intends to release draft legislation and transitional administrative guidance following a consultation process.

### *Clean energy generation equipment*

The budget extends eligibility for investment in specified clean energy generation and conservation equipment under capital cost allowance (CCA) regime Class 43.2 to property acquired before 2025 (from 2020). Under the capital cost allowance regime, Class 43.2 generally provides a 50% accelerated CCA rate on a declining-balance basis for investments in specified clean energy generation and conservation equipment.

## Personal Tax Changes

### *Reporting requirements for trusts*

The budget proposes to require reporting for certain trusts to provide additional information on an annual basis, including identity of all trustees, beneficiaries, settlors of the trust, and each person who has the ability (through the trust terms or a related agreement) to exert control over trustee decisions regarding the appointment of income or capital of the trust (e.g., a protector). The new reporting requirements will apply to express Canadian-resident trusts (i.e., generally, trusts created with the settlor's express intent) and non-resident trusts that are currently required to file a T3 return. The proposed new reporting requirements will apply to returns required to be filed for the 2021 and subsequent taxation years.

The budget proposes that the following trusts would be excluded from these additional reporting requirements:

- Mutual fund trusts, segregated funds and master trusts
- Trusts governed by registered plans (i.e., deferred profit sharing plans, pooled registered pension plans, registered disability savings plans, registered education savings plans, registered pension plans, registered retirement income funds, registered retirement savings plans, registered supplementary unemployment benefit plans and tax-free savings accounts)
- Lawyers' general trust accounts
- Graduated rate estates and qualified disability trusts
- Trusts that qualify as non-profit organizations or registered charities
- Trusts that have been in existence for less than three months or that generally hold less than $50,000 in assets throughout the taxation year.

The budget also introduces new penalties for a failure to file a T3 return (including a beneficial ownership schedule where required), equal to $25 for each day, with a minimum penalty of $100 and a maximum penalty of $2,500. If a failure to file the return was made knowingly or due to gross negligence, an additional penalty equal to 5% of the maximum fair market value of property held during the relevant year by the trust will apply, with a minimum penalty of $2,500. Existing penalties will also continue to apply. The penalties will also apply to returns required to be filed for the 2021 and subsequent taxation years.

### *Mineral exploration tax credit for flow-through share investors*

The budget extends eligibility for the mineral exploration tax credit for an additional year. As a result, the credit will apply to flow-through share agreements entered into on or before March 31, 2019.

### *Medical Expense Tax Credit — Specialty animals*

The budget proposes to expand the Medical Expense Tax Credit to recognize expenses incurred for an animal specially trained to perform tasks for a patient with a severe mental impairment in order to assist them in coping with their impairment (e.g., a psychiatric service dog trained to assist with post-traumatic stress disorder). Currently, this 15% non-refundable tax credit only applies to animals trained to help patients cope with impairments including blindness, profound deafness and severe autism. For 2018, the credit is available for qualifying medical expenses in excess of the lesser of $2,302 and 3% of the individual's net income. This measure will apply to eligible expenses incurred after 2017.

### *Deductibility of employee contributions to the QPP*

The budget provides a deduction for employee contributions (as well as the "employee" share of contributions made by self-employed persons) to the enhanced portion of the Quebec Pension Plan (QPP). Previously, Quebec announced that the enhanced portion of employee CPP and QPP contributions will be deductible for Quebec income tax purposes. This measure, which is intended to provide consistent income tax treatment of CPP and QPP contributions, will apply to the 2019 and subsequent taxation years.

### *Child benefit enhancements*

The budget allows foreign-born status Indians residing legally in Canada, who are neither Canadian citizens nor permanent residents, to be retroactively eligible for the Canada Child Tax Benefit, from the 2005 taxation year to June 30, 2016. Although these individuals are eligible for the Canada Child Benefit introduced in 2016, they were not eligible for the previous Canada Child Tax Benefit, which the new benefit replaced.

The budget also proposes to give legislative authority to the government to share with the provinces and territories taxpayer information related to the Canada Child Benefit, as of July 1, 2018.

### *Canada Workers Benefit*

The budget enhances the Working Income Tax Benefit, which has been now renamed the Canada Workers Benefit. This benefit, which is intended to improve work incentives 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 (i.e., couples and single parents). The budget notes that the benefit will be reduced by 12% of adjusted net income in excess of $12,820 for single individuals without dependants, and $17,025 for families. This measure will apply to the 2019 and subsequent taxation years, and indexation of these amounts will continue to apply after the 2019 taxation year.

The budget also increases the Canada Workers Benefit disability supplement to $700 in 2019, and the phase-out threshold of the supplement be increased to $24,111 for single individuals without dependants, and to $36,483 for families.

The budget also proposes to allow the CRA to determine if an individual is eligible to receive the Canada Workers 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 in respect of income tax returns for 2019 and subsequent taxation years

### *Registered Disability Savings Plan holders*

The budget proposes to extend the temporary program whereby a qualifying family member (i.e., a parent, spouse or common-law partner) can be the plan holder of an adult individual's RDSP where the capacity that individual to enter into a contract is in doubt. The budget extends this measure so that it expires in 2023 (from 2018).

## Charities

### *Charities — Municipalities and universities outside Canada*

Where the registration of a charity is revoked (either at the request of the charity or because the charity has not complied with its registration requirements), a 100% revocation tax applies to the charity, based on the total net value of its assets. A charity can reduce the amount of revocation tax by making qualifying expenditures.

The budget proposes to allow transfers of property to municipalities as qualifying expenditures for the purposes of the revocation tax, subject to case-by-case approval by the Minister of National Revenue. This measure will apply to transfers made on or after February 27, 2018.

The budget also 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, effective February 27, 2018.

## International Tax Changes

### *Cross-border surplus stripping using partnerships or trusts*

The cross-border anti-surplus-stripping rule seeks to prevent non-residents from achieving a tax benefit (increase in paid up capital) through a transfer of the shares of one corporation resident in Canada (the "Canadian subject corporation"), to another such corporation (the "Canadian purchaser corporation") with which the non-resident does not deal at arm's length, in exchange for shares of the Canadian purchaser corporation or other forms of consideration.

The rules address the use of a partnership as an intermediary, however they do not clearly address the situations where a non-resident person disposes of an interest in a partnership that owns shares of a Canadian subject corporation. Finance indicates that certain taxpayers were attempting to create cross-border paid-up capital by having a non-resident transfer shares of a Canadian subject corporation to a partnership in exchange for an interest in the partnership. The partnership interest would then be transferred to a Canadian purchaser corporation. Similar planning could also be carried out with trusts and in the context of a corporate migration.

The budget proposes to add a comprehensive "look-through" rule for such entities. These rules will allocate the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries, as the case may be, based on the relative fair market value of their interests.

This measure will apply to transactions that occur on or after February 27, 2018.

The budget includes proposed legislation to ensure that taxpayers cannot convert contributed surplus, arising from transactions to which the cross-border anti-surplus stripping rules apply, into paid-up capital, or include it in equity for the purposes of the thin capitalization rules.

This measure will apply to transactions that occur on or after February 27, 2018.

### *Trading or dealing in indebtedness*

Generally, where the principal purpose of a business carried on by a foreign affiliate is to derive income from trading or dealing in indebtedness, the income is treated as foreign accrual property income (FAPI) of the affiliate. Similar rules apply to ensure that income from an investment business is included in FAPI. These rules contain exceptions in respect of certain regulated foreign financial institutions.

Under the investment business rules, a taxpayer must satisfy certain minimum capital requirements in order to qualify for the regulated foreign financial institutions exception.

The budget proposes to add a similar minimum capital requirement to the trading or dealing in indebtedness rules.

This measure is effective to taxation years of a foreign affiliate that begin on or after February 27, 2018.

### *Controlled foreign affiliate status*

FAPI of a controlled foreign affiliate is included in income on an accrual basis. To avoid accrual taxation, certain groups of Canadian taxpayers have used tracking arrangements to avoid controlled foreign affiliate status (i.e., the group of taxpayers is sufficiently large that they take the position that they do not have, and do not participate in, a controlling interest in the affiliate). Under the tracking arrangement, each taxpayer retains control over its contributed assets and any returns from those assets accrue to its benefit.

The budget proposes to deem a foreign affiliate of a taxpayer to be a controlled foreign affiliate of the taxpayer if FAPI attributable to activities of the foreign affiliate accrues to the benefit of the taxpayer under a tracking arrangement.

This measure is effective to taxation years of a foreign affiliate that begin on or after February 27, 2018.

### *Foreign affiliates — Investment business*

A foreign affiliate of a taxpayer resident in Canada is a non-resident corporation in which the taxpayer has a significant interest. A controlled foreign affiliate of a taxpayer is generally a foreign affiliate in which the taxpayer has, or participates in, a controlling interest.

The taxpayer's share of the income of a foreign affiliate from an active business is not taxed until such time as it is paid as a dividend by the affiliate to the taxpayer. This dividend can be received tax-free to the extent that it is paid out of the foreign affiliate's exempt surplus. A foreign affiliate will have exempt surplus if it has income from an active business that it carries on in a country with which Canada has a tax treaty or a tax information exchange agreement (TIEA) and it is resident in such a country.

Certain income of a controlled foreign affiliate (i.e., income from property, from a business other than active business and from other specified sources) is taxable in the hands of the taxpayer in the year in which it is earned, regardless of whether it is distributed, with an offsetting deduction for taxes paid by the affiliate. This income is referred to as FAPI.

An investment business is generally defined as a business the principal purpose of which is to derive income from property. However, an investment business does not include a business carried on by a foreign affiliate if certain conditions are satisfied. One of these conditions, in general terms, is that the affiliate employ more than five full-time employees (or the equivalent) in the active conduct of the business.

Certain taxpayers whose foreign investment activities would not warrant more than five full time employees have engaged in tax planning with other taxpayers in similar circumstances seeking to meet the six employees test. This planning involves grouping their financial assets together in a common foreign affiliate in order to carry on investment activities outside of Canada through that affiliate. However, the contractual rights under these arrangements ensure that each taxpayer retains control over its assets and the returns to the assets accrue to the taxpayer (a tracking arrangement). The structure effectively converts passive income taxed on a current basis to active income which can be repatriated to Canada without tax.

The budget proposes to treat each of the activities carried out by the corporation in such a tracking arrangement to be a separate business and thus each separate business would have to satisfy the greater than five full-time employee test in order to be excluded from FAPI.

This measure is effective to taxation years of a foreign affiliate that begin on or after February 27, 2018.

### *Foreign affiliate reporting — Form T1134 filing deadline shortened*

The budget proposes to shorten the filing deadline for information returns that must be filed by a taxpayer in respect of its foreign affiliates to six months (from 15 months) after the taxpayer's year-end. This change aligns the information return filing deadline with the taxpayer's income tax return filing deadline.

This measure will apply to taxation years that begin after 2019.

**KPMG observations**
The budget documents do not specify the information return that will be impacted by this proposed filing deadline change. KPMG confirmed with a Finance official that this measure applies to Form T1134, "Information Return Relating To Controlled and Not-Controlled Foreign Affiliates".

### *Update on BEPS initiatives*

The budget does not contain specific BEPS changes, but reiterates Canada's intention to continue to work with its international tax partners to improve international dispute resolution, and to ensure a coherent and consistent response to fight cross-border tax avoidance.

The budget also notes Canada's important role in developing additional guidance on the following issues identified as part of the BEPS project:

- Attribution of profits to permanent establishments
- Use of the profit-split method
- Treatment of hard-to-value intangibles

Finance says that additional guidance in these areas is due to be published over the course of 2018.

Finance also says that Canada will be taking the steps to enact and ratify the Multilateral Instrument (MLI) in 2018. Additionally, Canada continues to expand its network of tax treaties and TIEAs.

### *Common reporting standard — Sharing of international tax data*

The recent implementation of the Common Reporting Standard allows jurisdictions to automatically exchange information on financial accounts held by non-residents. To properly leverage this information, the budget provides for $38.7 million over five years to the CRA to expand its offshore compliance activities, through the use of improved risk assessment systems and business intelligence, and will facilitate the hiring of additional auditors.

### *Audits involving foreign affiliates — Extended reassessment period*

The budget extends a taxpayer's reassessment period by three years in respect of income arising in connection with a foreign affiliate of the taxpayer.

Generally, the CRA has four years after its initial assessment to audit and reassess a taxpayer with foreign affiliates. Although there is a three-year extended reassessment period for assessments made as a consequence of a transaction involving a taxpayer and a non-resident with whom the taxpayer does not deal at arm's length, this extension does not apply in all relevant circumstances. The proposed measure is intended to ensure that the CRA has adequate time to examine all activities involving foreign affiliates.

This measure will apply to taxation years that begin on or after February 27, 2018.

## Indirect Tax Changes

### *GST/HST and investment limited partnerships*

The budget proposes changes to the draft legislation and regulatory proposals relating to the GST to investment limited partnerships that were released September 8, 2017. The new changes:

- Ensure the GST/HST applies to management and administrative services rendered by the general partner on or after September 8, 2017 (not before September 8,

2017, unless the general partner charged GST/HST in respect of such services before that date)

- Clarify that the GST/HST be generally payable on the fair market value of management and administrative services in the period in which these services are rendered

- Allow an investment limited partnership to make an election to advance the application of the special HST rules as of January 1, 2018.

### *Consultations on the GST/HST holding corporation rules*

The budget announces that Finance intends to soon release consultation documents and draft legislative proposals to address certain aspects of the holding corporation rule. This rule generally allows a parent corporation to claim input tax credits to recover GST/HST paid in respect of expenses that relate to another corporation. Specifically, Finance will accept public comments on the limitation of the rule to corporations and the required degree of relationship between the parent corporation and the commercial operating corporation. Further, Finance says it intends to clarify which expenses of the parent corporation, that are in respect of shares or indebtedness of a related commercial operating corporation, qualify for input tax credits under the rule.

### *Tobacco tax*

The budget proposes to increase the excise duty rate on tobacco products as follows:

- Cigarettes — Increase to $0.59634 for each five cigarettes or fraction thereof (from $0.53900)

- Tobacco sticks — Increase to $0.11927 per stick (from $0.10780)

- Manufactured tobacco — Increase to $7.45425 per 50 grams or fraction thereof (from $6.7375)

- Cigars — To $25.95832 per 1,000 cigars (from $23.46235)

The budget also increases the additional duty on cigars, to the greater of $0.09331 per cigar and 88% of the sale price or duty-paid value (from the greater of $0.08434 per cigar and 84%).

These measures will be effective as of February 28, 2018. The budget also proposes to advance the inflationary adjustments for tobacco excise duty so that they occur on an annual basis, rather than every five years. Starting in 2019, the inflationary adjustments will take effect on April 1 of every year.

In addition, the budget subjects inventories of cigarettes held by manufacturers, importers, wholesalers and retailers at the end of February 27, 2018 to a tax of $0.011468 per

cigarette (subject to certain exemptions). Taxpayers will have until April 30, 2018 to file returns and pay the cigarette inventory tax.

### *Cannabis tax*

The budget proposes a new federal excise duty framework for cannabis products that generally applies to all products available for legal purchase (i.e., fresh and dried cannabis, cannabis oils, seeds and seedlings for home cultivation). Under these rules, federally licensed cannabis cultivators and manufacturers (i.e., "cannabis licensees") will have to remit excise duty to the CRA, where applicable. The framework imposes excise duties at the higher of a flat rate applied on the quantity of cannabis in a final product, and a percentage of the dutiable amount of the product as sold by the producer. The dutiable amount generally represents the portion of the producer's sales price that does not include the cannabis duties. These rules will be introduced as part of the *Excise Act, 2001*.

The rules impose a flat rate duty at the time of packaging for final retail sale, on the quantity of cannabis flowering and non-flowering material (i.e., "flower" and "trim," respectively), as well as on cannabis seeds and seedlings. This duty will be imposed on a dollar-per-gram basis (or dollar per-seed/seedling basis). The rules apply a lower rate per gram to trim as to flower.

At the time a cannabis licensee that packaged a cannabis product delivers it to a purchaser, the framework imposes an ad valorem rate on the dutiable amount of the transaction. Cannabis licensees will be liable to pay duty at the higher of the flat rate or the ad valorem rate on the product. The applicable duty will only become payable at the time a product is delivered to a purchaser. A product will generally be considered to be "packaged" by a cannabis licensee when it is put in a container intended for sale to a final consumer at the retail level. The rules also require all cannabis products that will be removed from the premises of a cannabis licensee to enter into the Canadian market for retail sale to have an excise stamp.

The framework will come into effect when cannabis for non-medical purposes becomes available for legal retail sale. The excised duty would not apply to packaged products that contain concentrations of no more than 0.3% THC or pharmaceutical products that can only be acquired through a prescription.

Additionally, the budget proposes changes to ensure that any sales of cannabis products that would otherwise be considered as basic groceries are subject to the GST/HST in the same way as sales of other types of cannabis products. In addition, the budget specifies that sales of cannabis products, including seeds and seedlings, will not be eligible for the relieving rules for various agricultural products.

## Previously Announced Measures

The budget confirms that Finance will proceed with certain previously announced measures, as modified to take into account subsequent consultations and deliberations. The previously announced measures are:

- Income tax measures released on December 13, 2017 to address income sprinkling (for details on the proposed tax on split income rules, see *TaxNewsFlash-Canada* 2017-62, "Finance Provides Relief for Income Sprinkling Measures").
- Measures to lower the small business tax rate from to 10% (from 10.5%), effective January 1, 2018, and to 9%, effective January 1, 2019, which was included in a Notice of Ways and Means Motion tabled on October 24, 2017 along with related amendments to the gross-up amount and dividend tax credit for taxable dividends
- Information reporting requirements for certain dispositions of an interest in a life insurance policy, as announced in the 2016 federal budget
- Measures related to the division of a corporation under foreign laws, and to the requirements to qualify as a prescribed share, as released on September 16, 2016
- Measures relating to the Goods and Services Tax/Harmonized Sales Tax joint venture election, as previously confirmed in the 2016 federal budget
- Remaining legislative and regulatory proposals relating to the Goods and Services Tax/Harmonized Sales Tax that were released on September 8, 2017
- The income tax measure announced on October 24, 2017 in the Fall Economic Statement to provide for the indexing of the Canada Child Benefit amounts as of July 1, 2018 instead of July 1, 2020
- Expanded tax support for electrical vehicle charging stations and electrical energy storage equipment, as announced in the 2016 federal budget
- Additional tax relief for Canadian armed forces personnel and police officers, as announced on May 18, 2017
- Support for the establishment of a tax-exempt Memorial Grant for First Responders (the "Community Heroes" benefit), as announced in the 2017 federal budget.

The budget also reaffirms that Finance is committed to move forward with technical amendments to improve the certainty of the tax system.

## Administrative and Other Changes

### *Reassessment period for loss carrybacks — Non-resident non-arm's length persons*

The budget provides that the CRA has an additional three years to reassess a taxpayer's prior taxation year in certain cases. This extension will apply if the reassessment relates to the adjustment of a loss carryback resulting from CRA's reassessment of a taxation year as

a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length. The additional time period is only allowed where the reassessment reduces the taxpayer's loss for the taxation year that is available for carryback and all or any portion of that loss had been carried back to the prior taxation year.

The current loss-carryback reassessment period rules generally ensure that, where a loss arises in a taxation year and is carried back to a prior taxation year, the loss carried back cannot become statute-barred before the end of the reassessment period for the taxation year in which the loss arose. The rules do not, however, take into account that there is an extended three-year reassessment period for reassessments made as a consequence of a transaction involving a taxpayer and a non-arm's length person.

This measure will apply for taxation years in which a carried back loss is claimed, where the loss is carried back from a taxation year that ends on or after February 27, 2018.

This amendment applies in respect of challenges made after the measure receives Royal Assent.

### *Requirements for information and compliance orders*

The budget extends a taxpayer's reassessment period where the taxpayer contests a requirement for information or compliance order issued by the CRA. In these situations, the budget extends the reassessment period by the period of time the requirement or compliance order is contested. The period will generally start at the time the taxpayer makes an application for judicial review of the CRA's requirement for information or at the time the taxpayer opposes the CRA's application for a compliance order, as the case may be. The period will end upon the final disposition of the application, including any appeals.

This amendment is intended to prevent a taxpayer's ability to shorten the normal period during which the CRA may reassess a taxpayer (generally three or four years) by contesting requirements for information and compliance orders. While there are current "stop-the-clock" rules that extend the period open for reassessment where a taxpayer contests a CRA requirement for foreign-based information, there are no similar rules when a taxpayer challenges requirements for information that do not involve foreign-based information or compliance orders.

The budget states that the rules that currently apply with respect to requirements for foreign-based information will be amended to conform with the proposed amendments applicable to requirements for information and compliance orders.

This amendment applies in respect of challenges made after the measure receives Royal Assent.

### *Sharing of tax information relating to tax and non-tax offences*

The budget proposes to allow existing legal tools to be used to share criminal tax information under various international agreements including Canada's tax treaties and TIEAs.

In addition, the budget proposes to enable international sharing of tax information related to acts that, if committed in Canada, would constitute terrorism, organized crime, money laundering, criminal proceeds or designated substance offences. Further, the budget proposes to allow certain confidential excise tax related information to be disclosed to Canadian police officers.

### *Beneficial ownership*

Finance also proposes to strengthen the availability of beneficial ownership information by amending the *Canada Business Corporations Act*.

### *Increased funding*

The budget announces that Finance will provide new funding as follows:

- Finance will provide funding to support the federal courts, including the Tax Court of Canada. Specifically, Finance will provide $41.9 million over five years and $9.3 million per year on an ongoing basis to the Courts Administration Service.
- The CRA will receive $30 million over five years to enhance security measures to protect the confidentiality of personal and financial information of taxpayers.
- The CRA will receive support to develop an electronic platform for processing T3 returns
- Finance will invest $90.6 million over five years to address identified cases of domestic and international tax evasion and tax avoidance.

## We can help

Your KPMG adviser can help you assess the effect of the tax changes in this year's federal budget on your personal finances or business affairs, and point out benefits or help ease their impact. We can also keep you abreast of the progress of these proposals as they make their way into law.