TAXNET PRO NEWSLETTER

# FEDERAL BUDGET 2018

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## 2018 CANADIAN FEDERAL BUDGET COMMENTARY — TAX INITIATIVES

### INTRODUCTION

On February 27, 2018 (Budget Day), Finance Minister Bill Morneau tabled in the House of Commons the Liberal Government's third budget, *Equality & Growth: A Strong Middle Class* (Budget 2018).

Contrary to pre-budget rumours, which also circulated in 2017, Budget 2018 does not include measures increasing the capital gains inclusion rate. Nor does it include measures limiting loss carryovers or SR&ED tax credits. While Budget 2018 does not address the significant changes to the U.S. tax system which were enacted on December 22, 2017, it does state that over the coming months, the Canadian Department of Finance will conduct a detailed analysis of the U.S. federal tax reforms to assess any potential impacts on Canada.

All in all, the Finance Minister delivered a politically astute budget. There will still be deficits in the coming years, but at reduced levels. There are initiatives, among others, to grow the economy, to provide for regional development and to address barriers facing women entrepreneurs. Further, small business owners should be mollified by the simplified rules for the taxation of investment income earned by private corporations.

Our commentary on the tax initiatives in Budget 2018 follows. Unless otherwise stated, all statutory references are to the *Income Tax Act* (Canada) (Tax Act).

### BUSINESS TAX MEASURES

#### Passive Investment Income Earned by Private Corporations and Income Sprinkling

Under the Tax Act, active business income earned by a corporation is taxed at a rate that generally is significantly lower than the rates that apply to individuals. This is particularly true in the case of Canadian-controlled private corporations (CCPCs) on qualifying active business income. The lower corporate rates applicable to a corporation's business income are said by the Government to facilitate reinvestment in the business, thereby assisting the corporation in growing its business.

The lower tax rate applicable to a corporation earning active business income has provided a significant tax deferral opportunity where after-tax business income that is not reinvested in the business is used by the corporation for passive investment purposes rather than being paid out of the corporation to individual shareholders and used by them to earn investment income. Since such individuals would be subject to tax at personal income tax rates, the individuals would have fewer after-tax dollars to invest than the corporation.

The Government announced in Budget 2017 that it would be reviewing the use of tax planning strategies involving private corporations that, in the view of the Government, inappropriately reduce personal taxes of high-income earners. The strategies specifically identified by the Government included taking advantage of the fact that corporate income tax rates on business income are generally lower than personal tax rates to facilitate the accumulation of earnings that can be invested in a passive investment portfolio inside a private corporation (i.e., strategies that take advantage of the tax deferral opportunity available to private corporations and their shareholders). The Government proposed in Budget 2017 to address the issue in more detail in a paper to be released a few months after that budget. As contemplated, the Government released a consultation paper dealing with this issue on July 18, 2017. (As referred to below, the consultation paper also addressed “income sprinkling,” which the Government described as planning that involves diverting income from a high-income individual to family members who have lower personal tax rates or who may not be taxable at all.)

Although no legislation was proposed as part of the consultation paper, the Government indicated that one approach it was considering was to eliminate the refundability of taxes on investment income where earnings used to fund the investments were taxed at low corporate tax rates. In this approach, corporate tax on the passive investment income of private corporations would be approximately equal to the top personal tax rates, but no refund would be available as dividends were paid out.

Following the release of the consultation paper, the Government announced on October 18, 2017, that it was moving forward with its proposals as set out in the paper, but noted that it would alleviate the impact of the measures by:

a) grandfathering past investments and the income earned from such investments;

b) allowing for $50,000 of passive income to be earned annually in a private corporation without being subject to the proposed measures; and

c) working with the venture capital and angel investment sectors to ensure the proposed measures will not adversely impact them.

Budget 2018 addresses the Government’s objective of limiting the deferral advantage on passive investments made by private corporations using after-tax business profits, but it does so in a manner that is somewhat simpler than what had previously been proposed and that, at least for many corporations, will be less sweeping in scope.

Budget 2018 proposes two new measures, each of which is to apply to taxation years beginning after 2018. The first measure will limit access to the small business tax rate available to CCPCs on their qualifying active business income, and the second measure will limit access to refundable taxes on the payment of certain dividends.

*Passive Investment Income — Limiting Access to the Small Business Tax Rate*

The Tax Act provides a “small business deduction” (giving rise to what is often referred to as a small business tax rate), which reduces the rate of tax payable by a CCPC on its first $500,000 of qualifying active business income. This $500,000 business limit must be shared between associated corporations. The small business tax rate is phased out on a straight-line basis for associated CCPCs having between $10 million and $15 million of aggregate taxable capital employed in Canada.

Employing a measure similar to the phase-out for significant taxable capital, Budget 2018 proposes to phase out access to the small business tax rate for corporations that have significant passive investment income. In this regard, where a CCPC and its associated corporations earn more than $50,000 of passive income in their taxation years that ended in the prior calendar year, the amount of income eligible for the small business rate (the business limit) will be reduced by $5 for every $1 of investment income above the $50,000 threshold. Accordingly, the business limit will be reduced to zero at $150,000 of investment income.

This measure will affect only those CCPCs that access the small business tax rate and only to the extent that their qualifying active business income exceeds their reduced business limits. For example, a CCPC with $100,000 of investment income in one year would have its business limit reduced by $250,000 (i.e., $50,000 multiplied by five), such that it could earn up to $250,000 of eligible income that would be taxed at the small business rate (assuming no reduction for associated corporations, including by reason of aggregate taxable capital employed in Canada).

This new phase-out provision will operate along with the existing phase-out for aggregate taxable capital employed in Canada. The reduction in a corporation's business limit will be the greater of the reduction under this new measure and the reduction under the measure based on taxable capital.

In applying this new measure, a new concept of "adjusted aggregate investment income" will be introduced. It will be based upon "aggregate investment income," a measure that is currently used in computing the amount of refundable taxes in respect of a CCPC's investment income. In computing "adjusted aggregate investment income," the following adjustments will generally be made to the corporation's "aggregate investment income":

a) taxable capital gains (and allowable capital losses) will be excluded to the extent that they arise from the disposition of:
    i. a property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC; or
    ii. a share of another CCPC that is connected with the CCPC, where, in general, all or substantially all of the fair market value of the CCPC's assets is attributable directly or indirectly to assets used principally in an active business carried on primarily in Canada, provided that certain other conditions are satisfied;
b) net capital losses carried over from other taxation years will be excluded;
c) dividends from corporations that are not connected will be added; and
d) income from savings in a life insurance policy that is not an exempt policy will be added (except to the extent that it is otherwise included in aggregate investment income).

As is the case with "aggregate investment income," income that is incidental to an active business will not be included in "adjusted aggregate investment income."

Although this new rule will apply beginning in taxation years commencing after 2018, anti-avoidance rules will apply to the creation of a short taxation year (e.g., through an amalgamation) if one of the reasons for creating the short year was to defer application of the new rule. Similarly, an anti-avoidance rule will apply to the transfer or loan of property by a corporation to a related corporation that is not associated with it (e.g., a transfer from a corporation wholly owned by one spouse to a corporation wholly owned by another spouse) where one of the reasons for the transfer or loan was to avoid the reduction in the business limit pursuant to these new rules.

The Government explains in Budget 2018 that:

a) the $50,000 threshold is equivalent to the amount of investment income that would be earned on $1,000,000 in investment assets at a 5% rate of return; and
b) the full phase-out at $150,000 of investment income is equivalent to the amount of investment income that would be earned on $3,000,000 in investment assets at a 5% rate of return.

It is noteworthy that this proposed measure:

a) may have an impact on those corporations that were otherwise eligible for the small business tax rate and that had significant investment assets at the time that these changes were proposed (which is to some extent inconsistent with the Government's October 18, 2017, statement); but, perhaps more significantly,
b) will have no impact on corporations that earn business income that is not eligible for the small business deduction (e.g., corporations having aggregate taxable capital employed in Canada of at least $15 million). However, such corporations may be subject to the new measures targeting refundability of taxes on investment income.

*Refundability of Taxes on Investment Income*

Under the current system, investment income earned by a private corporation is subject to a high rate of tax roughly equivalent to the top tax rate, and a portion of the tax paid on such income is refunded to the corporation when the corporation pays taxable dividends to its shareholders. More specifically, a portion of the tax paid by the corporation on such investment income is added to the corporation's refundable dividend tax on hand (RDTOH) account, and is refundable at a rate of $38.33 for every $100 of taxable dividends paid to shareholders.

There are two types of taxable dividends that can be paid to shareholders: "eligible" dividends (which benefit from an enhanced dividend gross-up and are taxed at a lower rate in an individual's hands) and "non-eligible" dividends. While investment income earned by a private corporation must generally be paid to shareholders as non-eligible dividends, the RDTOH refund does not depend on whether a taxable dividend paid by the corporation is an eligible dividend or a non-eligible dividend. Accordingly, Budget 2018 observes that the current system can provide a tax deferral advantage on passive investment income by allowing private corporations paying eligible dividends sourced from active business income taxed at the general corporate income tax rate to generate a refund of taxes paid on passive income.

To address this perceived advantage and "better align" the refund of taxes paid on passive income with the payment of dividends sourced to passive income, Budget 2018 proposes to amend the rules to provide that, with one exception applicable where the payor corporation itself receives certain dividends referred to in the Budget documents as "eligible portfolio dividends," a refund of RDTOH will be available only in cases in which a private corporation pays non-eligible dividends. As described below, these new rules will apply for taxation years that begin after 2018, subject to an anti-avoidance rule designed to prevent the deferral of the new rules through the creation of a short taxation year. While the Budget documents describe the perceived advantage in relation to "larger CCPCs," the amendments will apply to all private corporations.

Under the new rules, a private corporation will have two RDTOH accounts: (i) a new account to be called the "eligible RDTOH" account, and (ii) the current RDTOH account, which will be renamed the "non-eligible RDTOH" account. If a corporation pays an eligible dividend, it will not be entitled to a dividend refund unless it has a positive balance in its eligible RDTOH account. If the corporation pays a non-eligible dividend, it will be entitled to a dividend refund provided it has a positive balance in either its eligible RDTOH account or its non-eligible RDTOH account. An ordering rule provides that where the corporation pays a non-eligible dividend, the non-eligible RDTOH account must be depleted before the corporation can obtain a refund from its eligible RDTOH account.

The non-eligible RDTOH account is essentially the current RDTOH account, with the exception that amounts added to the eligible RDTOH account (as described below) are excluded from the non-eligible RDTOH account.

As for the eligible RDTOH account, to the extent a corporation pays refundable tax under Part IV of the Tax Act on what the Budget documents refer to as "eligible portfolio dividends," such tax will be added to the corporation's eligible RDTOH account. To this end, eligible portfolio dividends are (i) eligible dividends received by the corporation from a corporation with which the corporation is not "connected" at the time of the dividend, and (ii) taxable dividends (eligible or ineligible) received by the corporation from another corporation with which the particular corporation is connected in respect of which payment the other corporation received a refund from its eligible RDTOH account. For this purpose, "connected" is defined to have the meaning assigned by subsection 186(4) and generally refers to corporations that are controlled by the recipient corporation or in which the recipient corporation owns shares entitling it to cast more than 10% of the votes and having a fair market value of more than 10% of the fair market value of all the issued shares.

Pursuant to a transitional rule, if the corporation is a CCPC throughout its first taxation year in respect of which the new rules apply, the corporation's eligible RDTOH account will include an amount equal to the lesser of (i) its RDTOH balance at the end of the prior taxation year (net of any dividend refund for that prior year), and (ii) 38 1/3% of the balance of its general rate income pool (GRIP, being the measure of the extent to which a CCPC can pay eligible dividends) at the end of the prior taxation year. In all other cases (i.e., where the corporation is not a CCPC throughout its first taxation year in respect of which the new rules apply), the corporation's RDTOH balance, if any, at the end of the prior year (net of any dividend refund for that prior year) will be allocated to the corporation's eligible RDTOH account.

While the above changes will generally apply to taxation years that begin after 2018, an anti-avoidance rule provides that the new rules will apply to a taxation year of a corporation that begins before 2019 and ends after 2018 if (i) the corporation's taxation year was, because of a transaction or event or series of transactions or events, shorter than it would have been in the absence of that transaction, event or series, and (ii) one of the reasons for the transaction, event or series was to defer the application of the new rules.

*Income Sprinkling*

As mentioned above, the second component of the Government's July 18, 2017, consultation paper addressed income sprinkling transactions. On December 13, 2017, the Government released draft legislation to expand the tax on split income (TOSI) in order to address the Government's concerns relating to such planning. In Budget 2018, the Government confirms its intention to proceed with the December 2017 measures.

*Revenue Impact*

The Government estimates that the changes dealing with income sprinkling and passive investment income will raise approximately $3.5 billion over the next five years.

**Clean Energy Assets**

Under the capital cost allowance system, accelerated capital cost allowance is provided in respect of the cost of certain properties used to generate renewable energy or conserve energy in order to encourage investment in these properties.

Capital cost allowance on property included in Class 43.1, which includes clean energy generation and energy conservation equipment, can be claimed on a 30% declining balance basis (subject to the half-year rule). Class 43.2 property includes property acquired before 2020 that would otherwise be included in Class 43.1. Capital cost allowance can be claimed on Class 43.2 property on a 50% declining balance basis (subject to the half-year rule).

Budget 2018 proposes to extend eligibility for Class 43.2 by five years so that property that would otherwise be included in Class 43.1 acquired before 2025 will be included in Class 43.2.

**Artificial Losses Using Equity-Based Financial Arrangements**

Budget 2018 continues the Government's ongoing cat-and-mouse game with corporate taxpayers, generally financial institutions, to close down transactions that allow a taxpayer to receive dividends on Canadian shares where the risk of loss or opportunity for gain or profit on the shares accrues to someone else.

With the now familiar refrain that "although these arrangements can be challenged by the Government based on existing rules in the [Tax Act ], these challenges could be both time-consuming and costly" (and, we might add, possibly unsuccessful), the Government is introducing specific legislation to clarify certain aspects of the synthetic equity arrangement (SEA) rules and the securities lending arrangement (SLA) rules to prevent taxpayers from realizing artificial tax losses through the use of arrangements intended to circumvent these rules. The Government anticipates the tax revenue impact from these measures to be $1.215 billion over five years.

*SEA Rules*

The dividend rental arrangement (DRA) rules originally targeted arrangements where it could reasonably be considered that the *main reason* for entering into an arrangement was to enable the person to receive a dividend on a Canadian share and under the arrangement someone else bears the risk of loss or enjoys the opportunity for gain or profit with respect to the share in any material respect. Subsection 112(2.3) denies the inter-corporate dividend deduction for a dividend received on a share in respect of which there is a DRA of the taxpayer.

Budget 2015 enacted the SEA rules to target transactions intended to circumvent the DRA rules in part by avoiding the main purpose requirement. Subject to certain exceptions, the Budget 2015 amendments essentially deny the inter-corporate dividend deduction on dividends received by a taxpayer on a Canadian share in respect of which there is a

SEA. In general terms, a SEA in respect of a Canadian share owned by a taxpayer is considered to exist where the taxpayer (or a person that does not deal at arm's length with the taxpayer) enters into one or more agreements or other arrangements that have the *effect* of providing to a counterparty all or substantially all of the risk of loss and opportunity for gain or profit in respect of the Canadian share. A SEA is treated as a DRA so that the dividend deduction denial rule in subsection 112(2.3) applies.

However, subsection 112(2.31) provides that the dividend deduction denial rule does not apply to a dividend received by a taxpayer on a share in respect of which there is a DRA because there is a SEA if the taxpayer establishes that no "tax-indifferent investor" or group of tax-indifferent investors (each member of which is affiliated with each other) has all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share because of the SEA (or a "specified SEA"). This condition is considered to have been met under subsection 112(2.32) if the taxpayer can obtain certain specific representations from its counterparty to the SEA.

The Government expresses the concern that certain taxpayers take the position that the exception can be met in circumstances where a tax-indifferent investor ultimately obtains all or substantially all of the risk of loss and opportunity for gain or profit of a Canadian share from a counterparty to the taxpayer otherwise than through a SEA or a specified SEA.

Budget 2018 proposes amendments to the no tax-indifferent investor exception to clarify 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, including where the tax-indifferent investor has not entered into a SEA or a specified SEA in respect of the share. To this end, paragraph 112(2.31)(b) will require that the taxpayer establish that no tax-indifferent investor or group of tax-indifferent investors (each member of which is affiliated with each other) has all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share. Conforming changes will be made to the representations that the taxpayer must obtain from its counterparty.

The proposed amendments will apply to dividends that are paid, or become payable, on or after Budget Day.

*Securities Lending Arrangements*

The Government states that it is aware that certain taxpayers may be entering into security lending and repurchase arrangements to seek the same unintended tax benefit that is targeted by the SEA rules.

In general terms, under these arrangements, a counterparty transfers or lends a Canadian share to a taxpayer, and the taxpayer agrees to transfer or return an identical share to the counterparty in the future. Over the term of the arrangement, the taxpayer is obligated to pay to the counterparty amounts (dividend compensation payments) as compensation for all dividends received on the transferred or lent Canadian share. If such an arrangement were a SLA as defined in section 260, the taxpayer's ability to deduct dividend compensation payments would be restricted.

The Government believes that certain taxpayers are entering into securities lending or repurchase arrangements that are designed to fail the requirements of the SLA definition in order to avoid the restriction on the deductibility of compensation payments. When a securities lending or repurchase arrangement does not meet that definition, dividend compensation payments made by the taxpayer will generally be fully deductible. In these circumstances, these taxpayers take the position that the DRA rules do not apply and claim an inter-corporate dividend deduction on the dividends received on the Canadian share, resulting in tax-free dividend income, while also deducting the amount of the dividend compensation payments.

Budget 2018 proposes to add a definition of "specified securities lending arrangement" (specified SLA). A specified SLA will be an arrangement (other than a SLA) under which:

a) a person (lender) transfers or lends a share that is listed on a designated stock exchange or that is a share of a "public corporation" to another person (borrower);
b) it may reasonably be expected that the borrower will transfer or return an identical share; and
c) the lender's risk of loss or opportunity for gain or profit is not changed in any material respect.

The definition of “SLA compensation payment” will be amended to include compensation paid pursuant to a specified SLA for an underlying payment. Consequently, subsection 260(5.1) will apply to the compensation payment received by the lender and the arrangement should be a DRA under paragraph (b) of the definition of a DRA. Therefore, the inter-corporate dividend deduction will be denied to the borrower, resulting in a dividend income inclusion that will offset the available deduction for the amount of the corresponding dividend compensation payment made to the lender under the arrangement.

Budget 2018 also proposes an amendment to clarify the interaction of two rules governing the deductibility of dividend compensation payments made by a taxpayer under a SLA. Under paragraph 260(6)(a), a registered securities dealer may deduct up to two-thirds of a dividend compensation payment to a counterparty. Subsection 260(6.1) allows all taxpayers to deduct the dividend compensation payment if the SLA is a DRA under paragraph (b) of the definition of DRA. The proposed amendment will clarify that paragraph 260(6)(a) does not apply when subsection 260(6.1) applies.

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

*Stop-Loss Rule on Share Repurchase Transactions Implemented by Financial Institutions*

The dividend stop-loss rules are intended to prevent abuse of the inter-corporate dividend deduction. In certain circumstances, the amount of a tax loss otherwise realized by a corporation on the disposition of shares is reduced by the amount of tax-deductible dividends received. Budget 2011 amended subsection 112(5) to provide that the dividend stop-loss rule in subsection 112(5.2) would apply if a financial institution was deemed to have received a dividend under subsection 84(3). Such a deemed dividend would arise if the issuer of the share repurchased the share from the financial institution otherwise than by an open market transaction.

However, the formula in subsection 112(5.2) under which the allowable loss is calculated was not changed, with the result that, even when applicable, it generally denies only 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 (PUC). The Government states that the portion of the tax loss equal to the mark-to-market income previously realized on the shares was allowed based on the premise that the financial institution already paid tax on that income. However, the Government asserts that as the repurchased shares would typically be fully hedged, any mark-to-market income realized on the shares due to their increase in value would be fully offset under the hedge. As a result, the Government asserts that the financial institution would realize an artificial tax loss on the share repurchase.

The Government asserts that Canadian financial institutions have continued to enter into these transactions with a view to obtaining these unintended tax benefits, and that while they can be challenged based on existing rules in the Tax Act, these challenges could be both time-consuming and costly.

Budget 2018 proposes to amend subsection 112(5.2) to provide that the tax loss otherwise realized on a share repurchase is generally decreased by the dividend deemed to be received on that repurchase when that dividend is eligible for the inter-corporate dividend deduction. The Government anticipates the tax revenue impact of these measures to be $1.35 billion over five years.

This measure will apply in respect of share repurchases that occur on or after Budget Day.

**At-Risk Rules for Tiered Partnerships**

The income (or loss) of a partnership for income tax purposes is allocated to its partners, who include (or deduct) the amount in calculating their own income. Limited partners of a partnership may deduct losses of the partnership allocated to them only to the extent of their “at-risk amount” in respect of the partnership. Losses of a partnership allocated to a limited partner in excess of their at-risk amount in respect of the partnership are not deductible and become “limited partnership losses,” which are generally eligible for an indefinite carry-forward. If eligible, these losses can be deducted in computing taxable income in a future year to the extent that the limited partner’s at-risk amount in the partnership has increased. Any undeducted limited partnership losses of the limited partner are reflected in the adjusted cost base of the partnership interest (since partnership losses other than undeducted limited partnership losses reduce the adjusted cost base of a partnership interest) resulting in a lower capital gain or higher capital loss on a disposition of the partnership interest.

Until a recent decision of the Tax Court of Canada which was affirmed by the Federal Court of Appeal (*Canada v. Green*), if a limited partner in a partnership was another partnership (a "tiered partnership structure"), the at-risk rules have been applied at the limited partner level, such that the limited partnership losses in respect of the lower partnership would not be eligible to be carried forward by the partnership holding the limited partnership interest since a partnership does not compute taxable income. However, such limited partnership losses would be reflected in the adjusted cost base of the limited partnership interest.

In the *Green* case, the Court held that the at-risk rules in a tiered partnership structure should be applied in computing the income of limited partners in the top partnership only. Budget 2018 reverses this decision by "clarifying" that the at-risk rules apply to a partnership that is a limited partner of another partnership. This measure, along with a number of consequential changes, will ensure that the at-risk rules apply at each level of a tiered partnership structure. In particular, for a partnership that is a limited partner of another partnership, the losses from the other partnership that can be allocated to the partnership's members will be restricted by that partnership's at-risk amount in respect of the other partnership. In the case of a top-tier partnership that would be allocated a loss in excess of its at-risk amount in the lower-tier partnership, the excess will be applied to reduce the loss otherwise allocated. The excess will not be treated as a limited partnership loss.

This measure will apply in respect of taxation years that end on or after Budget Day, including in respect of losses incurred in taxation years that end prior to Budget Day. In particular, losses from a partnership incurred in a taxation year that ended prior to Budget Day will not be available to be carried forward to a taxation year that ends on or after Budget Day if the losses were allocated — for the year in which the losses were incurred — to a limited partner that is another partnership.

### Health and Welfare Trusts

The tax treatment of health and welfare trusts is not provided for in the Tax Act. Rather, such trusts have been subject to published administrative positions of the Canada Revenue Agency (CRA).

Rules relating to employee life and health trusts were added to the Tax Act in 2010. Although these rules are very similar to the CRA's administrative positions for health and welfare trusts, they do not deal with identical issues.

Budget 2018 proposes that only one set of rules apply to both arrangements. More specifically, the CRA will no longer apply its administrative positions with respect to health and welfare trusts after the end of 2020, and transitional rules will be added to the Tax Act to facilitate the conversion of such trusts into employee life and health trusts. A health and welfare trust that does not convert to an employee life and health trust will be subject to normal income tax rules for trusts.

The Government invites stakeholders to submit comments on transitional issues to facilitate the discontinuation of the health and welfare trust regime by June 29, 2018.

## INTERNATIONAL TAX MEASURES

### Cross-Border Surplus Stripping

The PUC of shares of a Canadian corporation can generally be returned to non-resident shareholders without being subject to Canadian withholding tax. Distributions in excess of PUC are subject to withholding tax of 25% under Part XIII of the Tax Act (subject to possible treaty relief). Accordingly, PUC of a Canadian corporation is a valuable tax attribute for a non-resident shareholder.

There are surplus stripping provisions in the Tax Act that are intended to prevent a non-resident shareholder from entering into transactions to extract tax-free (or strip) a Canadian corporation's surplus in excess of the PUC of its shares, or to artificially increase the PUC of such shares. In particular, section 212.1 may apply on a transfer of shares of a Canadian corporation by a non-resident person or partnership to a non-arm's-length Canadian corporation. Where this rule applies, it can result in a deemed dividend to the non-resident transferor or the suppression of the PUC that would otherwise have been created as a result of the transaction.

The rule currently does not apply where a non-resident person disposes of an interest in a partnership that owns shares of a Canadian corporation. The Government believes that some taxpayers have attempted to exploit this by engaging in internal reorganizations that involve a non-resident transferring shares of a Canadian corporation to a partnership in exchange for an interest in the partnership. The partnership interest is then transferred to a non-arm's-length Canadian corporation.

The Government has stated its intention to ensure that the underlying purpose of the cross-border anti-surplus-stripping rule cannot be frustrated by transactions involving partnerships or trusts. Budget 2018 proposes to amend these provisions to add comprehensive "look-through" rules that will allocate the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries, as the case may be, on the basis of the relative fair market value of their interests. No specific proposed legislation was included in the Budget documents.

Budget 2018 also proposes specific amendments to address the conversion of contributed surplus to PUC without triggering a deemed dividend pursuant to subsection 84(1) and the use of contributed surplus in the definition of "equity amount" in subsection 18(5) that applies for purposes of the thin capitalization debt-to-equity ratio. More specifically, the amendments disregard contributed surplus that arose at a time when the corporation in question was a non-resident or that arose in connection with certain dispositions by a non-resident to a Canadian corporation under subsection 212.1(1.1).

These measures will apply to transactions that occur on or after Budget Day.

The Government notes that transactions that occur before Budget Day may be challenged using the general anti-avoidance rule, including where discretionary or similar interests are used for the purpose of obtaining inappropriate results under the proposed allocation mechanism.

### Foreign Affiliates

No specific legislation has been provided in respect of the following changes to the foreign affiliate regime proposed by Budget 2018.

*Investment Businesses*

Generally, a foreign affiliate of a taxpayer resident in Canada is a non-resident corporation in which the taxpayer and related persons have a 10% or greater interest. A controlled foreign affiliate of a taxpayer is generally a foreign affiliate in which the taxpayer has, or participates in, a controlling interest.

Certain passive income of a controlled foreign affiliate is taxable in the hands of the taxpayer in the year in which it is earned, whether or not it is distributed. This income is referred to as foreign accrual property income (FAPI).

Income from an investment business carried on by a foreign affiliate of a taxpayer is included in FAPI. The definition of investment business excludes businesses carried on by a foreign affiliate if certain conditions are satisfied, including a condition that the affiliate employs more than five full-time employees (or the equivalent) in the active conduct of the business. This is known as the “six employees test.” If the affiliate meets the six employees test and other conditions are satisfied, then the income from the investment business is treated as being from an active business and not FAPI. If a single foreign affiliate carries on multiple businesses, each such separate business must meet the six employees test.

The Government has raised the concern that certain taxpayers whose activities would not warrant more than five full-time employees have grouped their foreign financial assets together in a common foreign affiliate in what is known as a “tracking arrangement.” Such taxpayers have taken the position that the affiliate is carrying on a single business which meets the six employees test, and their respective investment returns are determined separately by reference to their contributed assets. This is done by way of share, contractual or other rights under which each taxpayer retains control over its contributed assets, and any returns from those assets accrue to their benefit.

Budget 2018 proposes to introduce a rule for the purposes of the definition of investment business so that where income attributable to specific activities carried out by a foreign affiliate accrues to the benefit of a specific taxpayer under a tracking arrangement, such activities will be deemed to be a separate business carried on by the affiliate. Each such separate business of the affiliate will therefore need to satisfy each relevant condition in the exclusion in the investment business definition, including the six employees test, for the income from that business to be excluded from FAPI.

This measure will apply to taxation years of a taxpayer’s foreign affiliate that begin on or after Budget Day.

The Government has indicated that even if the proposed legislation does not apply in a particular circumstance, the CRA may still determine, as a matter of fact, that certain arrangements give rise to separate businesses such that each would need to meet the six employees test.

*Controlled Foreign Affiliate Status*

The FAPI of a foreign affiliate of a taxpayer is included in the taxpayer’s income on an accrual basis only where the affiliate is a controlled foreign affiliate of the taxpayer. The Government is concerned that tracking arrangements are also being used to avoid controlled foreign affiliate status, in particular by having a group of taxpayers of sufficient number such that each taxpayer does not have, and does not participate in, a controlling interest in the affiliate. Again, under such tracking arrangements, each taxpayer retains control over its contributed assets and obtains the benefit of the returns on those assets.

Budget 2018 proposes to deem a foreign affiliate of a taxpayer to be a controlled foreign affiliate if FAPI attributable to its activities accrues to the benefit of the taxpayer under a tracking arrangement. This measure is intended to ensure that each taxpayer involved in such a tracking arrangement (no matter how large the group) is potentially subject to accrual taxation in respect of FAPI attributable to that taxpayer.

This measure will apply to taxation years of a taxpayer’s foreign affiliate that begin on or after Budget Day.

*Trading or Dealing in Indebtedness*

Where the principal purpose of a business carried on by a foreign affiliate of a taxpayer is to derive income from trading or dealing in indebtedness, the income from that business is generally treated as FAPI. Similar rules apply to ensure that income from an investment business is generally included in FAPI. Both sets of rules contain exceptions in respect of certain regulated foreign financial institutions, but minimum capital requirements must be satisfied to benefit from these exceptions in the case of investment businesses.

To ensure consistency with the investment business rules, Budget 2018 proposes to add a similar minimum capital requirement for these exceptions to apply to the trading or dealing in indebtedness rules.

This measure will apply to taxation years of a taxpayer’s foreign affiliate that begin on or after Budget Day.

*Reassessments*

The CRA generally has three or four years (depending on the taxpayer) after the date of the taxpayer's initial assessment (referred to as the "normal reassessment period") in which to audit and reassess the taxpayer, after which the CRA is generally barred from reassessing. There is currently a three-year extension to the reassessment period in respect of assessments made as a consequence of a transaction involving a taxpayer and a non-arm's-length non-resident, but the extension may not apply to all transactions involving foreign affiliates.

Budget 2018 proposes to extend the reassessment period for a taxpayer by three years in respect of income arising in connection with a foreign affiliate of the taxpayer.

This measure will apply to taxation years of a taxpayer that begin on or after Budget Day.

*Reporting Requirements*

Taxpayers (and certain partnerships) are required by section 233.4 to file an information return (T1134) each year in respect of each of their foreign affiliates. Most entities that file these information returns are corporations. Although a corporate taxpayer is typically required to file its income tax return within six months of the end of its taxation year, its information return in respect of its foreign affiliates is not due until 15 months after such taxation year-end.

Budget 2018 proposes to require the information returns to be filed within six months of the end of the taxpayer's taxation year to match the corporate return deadline.

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

**Reassessment Period – Requirements for Information and Compliance Orders**

Where the CRA issues a requirement for foreign-based information that is contested in court by the recipient of the requirement, a "stop-the-clock" rule in subsection 231.6(7) provides that the running of the reassessment period is paused while the requirement is contested.

No similar rule applies when challenges are made to requirements for information that do not involve foreign-based information and compliance orders.

Budget 2018 proposes to amend the Tax Act to introduce a stop-the-clock rule for requirements for information generally and for compliance orders. This rule will extend the reassessment period of a taxpayer by the period of time during which the requirement or compliance order is contested. The stop-the-clock period will end upon the final disposition of the application contesting the requirement or order (including any appeals). Related amendments will also be made to conform the rules applicable to requirements for foreign-based information.

This measure will apply in respect of challenges instituted after royal assent to the enacting legislation.

**Reassessment Period – Non-Resident Non-Arm's-Length Persons**

If a taxpayer incurs a loss in a taxation year and carries the loss back to deduct against its income in a prior taxation year, the reassessment period for that prior year is extended by three years. The Government notes that the extended reassessment period is intended to ensure that where a loss arises in a taxation year and is carried back to be used in a prior taxation year, the loss carried back to the prior taxation year cannot become statute-barred before the end of the reassessment period for the taxation year in which the loss arose.

An extended three-year reassessment period also exists in respect of reassessments made as a consequence of a transaction involving a taxpayer and a non-arm's-length non-resident person; however, the loss carryback reassessment period does not take into account this extended period.

Budget 2018 proposes to amend the Tax Act to provide the CRA with an additional three years to reassess a prior taxation year if the reassessment relates to the adjustment of the loss carryback, where (i) a reassessment of a taxation year is made as a consequence of a transaction involving the taxpayer and a non-arm's-length non-resident person; (ii) the reassessment reduces the taxpayer's loss for the taxation year that is available for carryback; and (iii) all or a portion of the loss has been carried back by the taxpayer to the prior taxation year.

The Government provided the following example: a loss arises in a taxpayer's 2017 taxation year and the taxpayer carries back this loss and deducts it against income in its 2014 taxation year. In 2023, the CRA determines that the actual amount of the 2017 loss is less than the amount claimed as a consequence of an adjustment to a transaction involving a taxpayer and a non-arm's-length non-resident person. The CRA will now be able to reassess the 2014 taxation year to the extent that the reassessment relates to the adjustment of the loss carryback.

This measure will apply in respect of taxation years in which a carried back loss is claimed where that loss is carried back from a taxation year that ends on or after Budget Day.

**Sharing Information for Criminal Matters**

Canada has entered into numerous tax treaties and tax information exchange agreements (TIEAs) and is a party to the *Convention on Mutual Administrative Assistance in Tax Matters* (the Convention). Such agreements provide for the sharing of tax-related information for both civil and criminal tax law purposes, subject to the confidentiality provisions of the agreement at issue. Canada has also entered into numerous mutual legal assistance agreements, which provide for the sharing of information for criminal law purposes.

*Sharing Tax Information Relating to Tax Offences*

Budget 2018 proposes to permit the legal tools available under the *Mutual Legal Assistance in Criminal Matters Act* (MLACMA) to be used with respect to the sharing of criminal tax information under Canada's tax treaties and TIEAs, and the Convention. These tools include the ability for the Attorney General to obtain court orders to gather and send information.

To give effect to this measure, the Government has indicated that legislative amendments may be proposed to the MLACMA, the Tax Act, Part IX of the *Excise Tax Act* (in relation to the goods and services tax/harmonized sales tax [GST/HST]) and the *Excise Act, 2001* (in relation to excise duties on products such as tobacco and alcohol).

The Government intends to propose that any such amendments come into force upon royal assent to the enacting legislation.

*Sharing Tax Information Relating to Serious Non-Tax Offences*

Mutual legal assistance agreements entered into by Canada provide for international cooperation in criminal matters between signatory countries. The Government can enter into case-specific arrangements to respond to requests for mutual legal assistance. The MLACMA authorizes the Attorney General to obtain gathering and sending orders for information relating to serious non-tax offences, but tax information cannot currently be obtained or shared by Canada (unlike many of its counterparts) through this process.

Budget 2018 proposes to enable the sharing of tax information with Canada's mutual legal assistance partners in respect of acts that, if committed in Canada, would constitute terrorism, organized crime, money laundering, criminal proceeds or designated substance offences (for example, offences listed in section 462.48 of the *Criminal Code*).

The Government indicates that a similar issue relates to the authority of the Attorney General to apply for a court order to allow Canadian police officers to obtain taxpayer information under the Tax Act for an investigation or prosecution of those offences. Currently, there is no ability to obtain similar confidential information under Part IX of the *Excise Tax Act* or the *Excise Act, 2001*.

In this regard, Budget 2018 proposes to enable confidential information under Part IX of the *Excise Tax Act* and the *Excise Act, 2001* to be disclosed to Canadian police officers in respect of those offences where such disclosure is currently permitted in respect of taxpayer information under the Tax Act.

Legislative amendments may be proposed to the MLACMA, the *Criminal Code*, the Tax Act, Part IX of the *Excise Tax Act* and the *Excise Act, 2001* to give effect to these measures. The Government intends to propose that any such amendments come into force upon royal assent to the enacting legislation.

### Combatting Aggressive International Tax Avoidance

*Update on International Tax Avoidance — Base Erosion and Profit Shifting*

Canada has been a participant in the Organisation for Economic Co-operation and Development/Group of Twenty (OECD/G20) project to address what is, in the Government's view, the inappropriate shifting of profit offshore and other international planning to avoid tax by corporations and certain individuals, known as the base erosion and profit shifting (BEPS) initiative.

In Budget 2018, the Government states that Canada intends to adopt new anti-treaty-shopping and anti-treaty abuse rules in its tax treaties, including such provisions that may be adopted under the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). The Government also notes that Canada has adopted revised OECD Transfer Pricing Guidelines, and has provided guidance on issues identified in the course of the BEPS project, including the attribution of profits to permanent establishments, the use of the profit split method and the treatment of hard-to-value intangibles. Additional guidance is due to be published over the course of 2018.

The MLI is intended to allow participating jurisdictions to modify their existing tax treaties to include measures developed under the OECD/G20 BEPS project without having to individually renegotiate those treaties. In Budget 2018, the Government indicates that in 2018, Canada will be taking the steps necessary to enact the MLI into Canadian law and to expand and update its network of tax treaties and TIEAs.

*Common Reporting Standard — Sharing of International Tax Data*

The implementation of the OECD/G20 Common Reporting Standard allows jurisdictions to automatically exchange information on financial accounts held by non-residents. The Government will provide $38.7 million over five years to the CRA to facilitate the hiring of additional auditors and to expand its offshore compliance activities through the use of improved risk assessment systems and business intelligence. These funds are intended to ensure that the information received is properly used to address the highest-risk population of tax evaders.

## PERSONAL TAX MEASURES

### Canada Workers Benefit

*Enhancement*

The 2017 Fall Economic Statement announced the Government's intention to enhance the Working Income Tax Benefit (to be renamed the Canada Workers Benefit) by an additional $500 million per year, starting in 2019.

Budget 2018 proposes measures to implement increases to the benefit, as well as to the supplement for individuals who are eligible for the Disability Tax Credit.

This measure will apply to the 2019 and subsequent taxation years. Indexation of amounts relating to the Canada Workers Benefit will continue to apply after the 2019 taxation year.

*Improving Access*

Budget 2018 proposes to allow the CRA to determine whether an individual who did not claim the new Canada Workers Benefit is eligible to receive the benefit and assess the individual's return as if the benefit had been claimed. In the case of eligible couples in which neither partner makes a claim, the CRA will designate which spouse or common-law partner receives the benefit.

This measure will apply for 2019 and subsequent taxation years.

To assist in the administration of the Canada Workers Benefit, Budget 2018 also proposes that designated educational institutions in Canada be required to report, to the CRA, prescribed information pertaining to students' enrolment, effective for months of enrolment after 2018.

### Medical Expense Tax Credit — Eligible Expenditures

Budget 2018 proposes to expand the Medical Expense Tax Credit to recognize expenses for an animal that is specially trained to perform tasks for a patient who has a severe mental impairment to assist the patient in coping with his or her impairment.

This measure will apply in respect of eligible expenses incurred after 2017.

### Registered Disability Savings Plan

In general, if an adult individual is not contractually competent to enter into a disability savings plan, the Tax Act requires that the plan holder of the individual's registered disability savings plan (RDSP) be the individual's legal representative, as recognized under provincial or territorial law.

As a temporary measure, the Tax Act allows a qualifying family member (such as a parent, spouse or common-law partner) to be the plan holder of the individual's RDSP if a legal representative is not in place. This measure is to expire at the end of 2018. Budget 2018 proposes to extend the temporary measure to the end of 2023. Budget 2018 also provides that a qualifying family member who becomes a plan holder before the end of 2023 could remain the plan holder after 2023.

### Deductibility of Employee Contributions to the Enhanced Portion of the Quebec Pension Plan

As part of the Canada Pension Plan (CPP) enhancement that was announced in 2016, the Tax Act was amended to provide a tax deduction for employee contributions (including the "employee" share of contributions made by self-employed persons) to the enhanced portion of the CPP.

On November 2, 2017, the Government of Quebec announced that the Quebec Pension Plan (QPP) would be enhanced in a manner similar to the enhancement of the CPP.

Budget 2018 proposes to amend the Tax Act to provide a deduction for employee contributions (including the "employee" share of contributions made by self-employed persons) to the enhanced portion of the QPP.

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

### Child Benefits

*Foreign-Born Status Indians*

The current Canada Child Benefit was introduced in July 2016 to replace the previous child benefit system, which consisted of the Canada Child Tax Benefit, the National Child Benefit supplement and the Universal Child Care Benefit.

Foreign-born status Indians residing legally in Canada who are neither Canadian citizens nor permanent residents under the *Immigration and Refugee Protection Act* are eligible for the Canada Child Benefit if all other eligibility requirements are met. However, these individuals were not eligible under the previous child benefit system.

Budget 2018 proposes that such individuals be made retroactively eligible for the previous child benefit system if all other eligibility requirements are met.

This amendment applies from the 2005 taxation year to June 30, 2016.

### Access to Taxpayer Information

Budget 2018 proposes to amend the Tax Act to provide the Government with legislative authority to share taxpayer information related to the Canada Child Benefit with the provinces and territories, to assist in the administration of their social assistance payment regimes.

This measure will apply as of July 1, 2018.

### Charities — Miscellaneous Technical Issues

*Municipalities as Eligible Donees*

When a charity's registration is revoked, the Tax Act imposes a 100% revocation tax on the charity based on the total net value of its assets. A charity can reduce the amount of revocation tax by making qualifying expenditures, including gifts to "eligible donees." Currently, municipalities are not eligible donees.

Budget 2018 proposes to amend the Tax Act so that transfers of property to municipalities will be considered qualifying expenditures for the purposes of the revocation tax, subject to the approval of the Minister of National Revenue on a case-by-case basis.

This measure will apply to transfers made on or after Budget Day.

*Universities Outside Canada*

Taxpayers may claim a charitable donation tax credit or deduction for donations made to "qualified donees."

To simplify the administration of the rules, Budget 2018 proposes to remove the requirement that a university outside Canada be prescribed in the *Income Tax Regulations* in order to be a qualified donee. Such organizations must still comply with registration requirements introduced in 2011.

This measure will apply as of Budget Day.

### Mineral Exploration Tax Credit for Flow-Through Share Investors

Resource companies can renounce or "flow through" tax expenses associated with their Canadian exploration activities to investors who acquire flow-through shares. The mineral exploration tax credit provides a further income tax benefit for individuals who invest in mining flow-through shares. This credit is equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

Budget 2018 announces the Government's proposal to extend the credit for an additional year, until March 31, 2019.

### Reporting Requirements for Trusts

Trusts are generally required to file an annual return of income (T3) only if they have tax payable or make distributions to their beneficiaries. A trust is not required to report the identity of its beneficiaries in its T3. As a result, the Government perceives there to be significant gaps in the information that is collected with respect to trusts.

*Reporting Requirements and Penalties*

Budget 2018 proposes to provide funding to the CRA for the development of an electronic platform for processing T3 returns in order to implement new reporting requirements and improve the audit and assessment of trusts.

Budget 2018 also proposes to require certain trusts to file a T3 return where such obligation does not currently exist and to require trusts to provide additional information such as the identity of trustees, beneficiaries and settlors, as well as the identity of protectors and other persons who are able to exert control over trustee decisions regarding the appointment of income or capital.

Subject to certain exceptions, the new reporting requirements will apply to express trusts (generally trusts created with the settlor's express intent) and to non-resident trusts that are currently required to file a T3 return.

The new reporting requirement will not apply to mutual fund trusts, trusts governed by registered plans, lawyers' general trust accounts, graduated rate estates, qualified disability trusts, trusts that qualify as non-profit organizations or registered charities, and trusts that have been in existence for less than three months. They also will not apply to trusts that hold less than $50,000 in assets throughout the taxation year and that confine their holdings to deposits, government debt obligations and listed securities.

A penalty will be introduced for a failure to file a T3 return, including the beneficial ownership schedule for those trusts subject to the new reporting requirements. The penalty will be equal to $25 for each day late, with a minimum penalty of $100 and a maximum penalty of $2,500. If the failure is made knowingly or is due to gross negligence, an additional penalty will apply equal to 5% of the maximum fair market value of property held by the trust during the relevant year, with a minimum penalty of $2,500. Existing penalties will continue to apply.

The proposed reporting requirements and penalties will apply for the 2021 and subsequent taxation years.

## SALES AND EXCISE MEASURES

### GST/HST and Investment Limited Partnerships

Budget 2018 confirms the Government's intention to implement the measures announced by the Government in September 2017 relating to the application of GST/HST to investment limited partnerships. The measures already announced are largely confirmed in Budget 2018.

The September measures proposed to impose GST/HST on the fair market value of management and administrative services provided to an investment limited partnership by its general partner where consideration becomes due or is paid on or after September 8, 2017. These measures also proposed to broaden the definition of financial institution under the *Excise Tax Act* to include investment limited partnerships. The specific GST/HST rules applicable to financial institutions would, therefore, potentially become applicable to investment limited partnerships. This proposed amendment was set to apply to any taxation year of an investment limited partnership commencing after 2018. The measures also included a specific residency rule for investment limited partnerships, resulting in the zero-rating treatment of certain services provided to an investment limited partnership where 95% or more of the value of its interests are held by non-residents of Canada.

Budget 2018 introduces the following changes to the previously announced draft proposals.

Budget 2018 clarifies that the GST/HST does not apply to management and administrative services rendered by the general partner prior to September 8, 2017, unless taxes were charged by the general partner before this date.

In terms of timing of the tax payable, practitioners had expressed concern that it may be difficult to determine when the services were rendered and when the liability to pay or collect tax would arise. Budget 2018 attempts to address this concern. In general terms, Budget 2018 clarifies the timing of the GST/HST liability in a situation in which there is an agreement providing for the particular supply of management or administrative services, and the services are ongoing services, split into billing periods. In such a situation, the supplies of such services by the general partner, which are deemed separate supplies for each reporting period under existing rules, are deemed to be made for consideration that becomes due on the last day of the reporting period, in an amount equal to the fair market value of the services provided during the billing period.

Budget 2018 also clarifies that in a situation in which there is an agreement providing for the particular supply of management or administrative services, but the services are not ongoing services split into billing periods, the general partner is deemed to have made a separate supply of services. In this regard, a separate supply is deemed to have been made for each of the reporting periods of the general partner during which the services are rendered. Each of those supplies is deemed to be made on the first day of the reporting period of the general partner for consideration that becomes due on the last day of the reporting period, in an amount equal to the fair market value of the services rendered by the general partner in the given period.

Where there are no agreements providing for the particular supply of management or administrative services, Budget 2018 proposes that the supply of the services be deemed to be made for consideration that becomes due at the time the supply is made, in an amount equal to the fair market value of the services when they are acquired by the limited partnership.

Budget 2018 also proposes to allow investment limited partnerships to elect to qualify as financial institutions for the purpose of the specific GST/HST rules applicable to such institutions as of January 2018 instead of January 2019, as was provided for under the measures originally proposed.

**Tobacco Taxation**

Inflation is currently accounted for in the rates of excise duty on tobacco products through adjustments made every five years. Budget 2018 proposes to advance the existing inflationary adjustments to occur on an annual basis. Inflationary adjustments will take effect on April 1 of every year, starting in 2019. Tobacco excise duty rates will be adjusted on February 28, 2018, to account for inflation since the last inflationary adjustment in 2014.

Budget 2018 also proposes to increase tobacco excise duty rates on cigarettes, tobacco sticks, manufactured tobacco and cigars, including as follows:

a) an additional $1 per carton of 200 cigarettes, along with corresponding increases to the excise duty rates on other tobacco products; and
b) an inventory tax of $0.011468 per cigarette (subject to certain exemptions) applicable to inventories of cigarettes held by manufacturers, importers, wholesalers and retailers at the end of Budget Day.

**Cannabis Taxation**

Budget 2018 proposes an excise duty framework for the taxation of cannabis products to be introduced in the *Excise Act, 2001.* The framework is set to come into effect when cannabis for non-medical purposes becomes available for legal retail sale, the timing of which will effectively depend on the implementation of the various retail networks across Canada.

Under the framework, duties will generally apply to all products available for legal purchase, which will include fresh and dried cannabis, cannabis oils, and seeds and seedlings for home cultivation. Excise duties will apply to cannabis products that contain more than 0.3 % Tetrahydrocannabinol (THC), the primary psychoactive compound of cannabis. However, pharmaceutical products approved by Health Canada will not be subject to the excise duty.

Excise duties will be imposed on federally licensed producers at the higher of a flat rate applied on the quantity of cannabis contained in a final product and a percentage of the dutiable amount of the product as sold by the producer.

All cannabis products that are removed from the premises of a federally licensed cannabis producer to enter into the Canadian market for retail sale will be required to have appropriate excise stamps.

Regarding the effective date of this framework, duties will become payable by cannabis licensees on any cannabis product they have already delivered in advance of the legalization date for eventual retail sale, with the exclusion of cannabis delivered to final consumers through the mail in accordance with the *Access to Cannabis for Medical Purposes Regulations*. Cannabis cultivators and manufacturers will be required to obtain a cannabis licence from the CRA and remit the excise duty, where applicable.

It is important to note that GST/HST will apply to cannabis products and that the *Excise Tax Act* will be amended to ensure that cannabis products are not considered zero-rated (as are the basic grocery or agricultural products zero-rating provisions), such that they will remain taxable products.

Budget 2018 also sets forth the federal-provincial cannabis taxation coordinated framework. The coordinated framework provides for the application of a federal excise duty as well as an additional excise duty in respect of provinces and territories. Federal excise duties will be shared with the provinces and territories on the following basis:

a) 75% of the taxation revenues from a combined $1 per gram/10% excise duty rate will flow to participating provinces and territories, with the federal government receiving the remaining 25%; and

b) the federal portion of cannabis excise duty revenues will be capped at $100 million annually for the first two years after legalization, with any additional cannabis excise duty revenues to be distributed to the participating provinces and territories.

The additional excise duty in respect of a province or territory will apply in provinces and territories that agree to participate in the coordinated framework and will apply on the same tax base as, and in fixed proportion to, the federal rate. While Budget 2018 refers to the additional proposed duty rates for the provinces and territories, the provinces and territories will be entitled to request an adjustment or increase of these rates.

### Consultations on the GST/HST Holding Corporation Rules

The "holding corporation rule" generally allows a Canadian resident parent corporation to claim input tax credits to recover GST/HST paid in respect of expenses that relate to a related corporation to the extent that this other corporation is engaged in commercial activities. It is a rule extending the right of certain companies that do not carry on commercial activities to claim input tax credits in specific circumstances.

In Budget 2018, Government states its intention to consult on certain aspects of the holding corporation rule, and refers to the limitation of the rule to corporations and the required degree of relationship between a parent corporation and the commercial operating corporation. The Government also expresses its intention to clarify which expenses of the parent corporation would be considered as being in respect of shares or indebtedness of a related commercial operating corporation and would qualify for input tax credits under the rule.

## TRADE AND TARIFF MEASURES

Budget 2018 proposes to amend the *Canadian International Trade Tribunal Act* for the purpose of ensuring that it continues to effectively deliver on its mandate.

Budget 2018 also states the Government's intention to introduce legislation streamlining Canada's customs tariff legislation to simplify its structure and administration. Since there was comparatively little detail on these measures provided in the Budget documents, further details will need to be announced in respect of these proposals.

In addition, Budget 2018 proposes to create and fund the Canadian Ombudsperson for Responsible Enterprise. This office will be responsible for ensuring that Canadian firms operating abroad employ proper ethical, social and environmental practices. The office will be empowered to investigate, report and recommend remedial actions for any human rights abuses by Canadian firms abroad.

## PREVIOUSLY ANNOUNCED MEASURES

Budget 2018 confirms the Government's intention to proceed with certain previously announced tax and related measures, as modified to take into account consultations and deliberations since their release, including the following:

a) measures confirmed in Budget 2016 relating to the GST/HST joint venture election;

b) income tax measures announced in Budget 2016 expanding tax support for electrical vehicle charging stations and electrical energy storage equipment;

c) the income tax measure announced in Budget 2016 on information-reporting requirements for certain dispositions of an interest in a life insurance policy;

d) technical income tax legislative amendments released on September 16, 2016, relating to a division of a corporation under foreign laws and to the requirements to qualify as a prescribed share;

e) the income tax measure announced on May 18, 2017, for additional tax relief for Canadian armed forces personnel and police officers;

f) remaining legislative and regulatory proposals released on September 8, 2017, relating to the GST/HST;

g) the income tax measure announced on October 16, 2017, to lower the small business tax rate from 10.5% to 10%, effective January 1, 2018, and to 9%, effective January 1, 2019, along with related amendments to the gross-up amount and dividend tax credit for taxable dividends;

h) the income tax measure announced on October 24, 2017, to provide for the indexing of the Canada Child Benefit amounts as of July 1, 2018, instead of July 1, 2020; and

i) income tax measures released on December 13, 2017, to address income sprinkling.

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