2019 Federal Budget Commentary

March 19, 2019

Stern Cohen LLP
Chartered Professional Accountants
Chartered Accountants
Licensed Public Accountants
Business Advisors

45 St. Clair Avenue West, 14th Floor, Toronto ON Canada M4V 1L3
T. 416-967-5100 E. contact@sterncohen.com www.sterncohen.com

FEDERAL BUDGET COMMENTARY 2019

Finance Minister Bill Morneau's Budget 2019 message is that, thanks to the Federal Government's investments over the past three years, things are going well — especially for the middle class. More Canadians have full-time jobs, unemployment is at historic lows, wages are growing, consumers and businesses are confident, economic growth is good, and our debt is manageable.

Nonetheless, Morneau says more needs to be done to ensure Canadians prosper over the coming years. For the most part, that means adding tax credits, incentives, enhancements, giving the Canada Revenue Agency more resources to recover unpaid taxes and to help businesses comply, taking measures to reduce tax evasion and aggressive tax avoidance, improving retirement and disability savings plans, and introducing the framework for a national prescription drug plan.

The budget does not contain significant changes to personal and business tax rates, nor does it make substantive efforts to improve the efficiency of the *Income Tax Act.* There are no significant cuts intended to reduce the deficit.

Specific measures in the Budget include:

- A new, non-taxable Canada Training Credit for eligible workers aged 25 to 64
- A new Employment Insurance Training Support Benefit
- Increasing the RRSP withdrawal limit under the First-Time Home Buyers' Plan
- Preferred capital gains tax treatment for owners of multi-unit residential properties
- Increased access to the enhanced 35 per cent scientific research and experimental development tax credit
- Limits on the employee stock option deduction for large, long-established, mature companies
- Broadening the tax rules for certain registered plans to allow new types of annuities
- Changing the rules for Registered Disability Savings Plans to better protect the long-term savings of persons with disabilities
- Making zero-emission vehicles eligible for a 100 per cent capital cost allowance rate in the year they are put in use
- Reallocating the CRA's resources to improve digital services, provide more timely resolution to taxpayers' objections, and adding CRA auditors to help new unincorporated businesses understand their tax obligations and extending the program to incorporated businesses
- Increasing CRA staff to reduce the time it takes to process T1 post-filing adjustments
- New CRA audit teams to detect and pursue complex real estate transactions where parties have not paid the required taxes

In brief, the 2019 Budget includes $22.8 billion in new spending over the next five years. The government expects revenues to steadily increase by nearly $60 billion in 2023 and projects program spending to increase by $40 billion that year. Debt payments are projected to increase by $7 billion.

Based on these growth and spending assumptions, the government expects the federal deficit to increase to nearly $20 billion in 2019–2020 and 2020–21 and then decline to $9.8 billion at the end of the next five years.

BUSINESS INCOME TAX MEASURES

Scientific Research & Experimental Development (SR&ED)

Canadian-controlled private corporations (CCPCs) or associated groups of such corporations, are entitled to an enhanced (35 per cent vs 15 per cent) federal tax credit based on up to $3,000,000 of current SR&ED expenditures incurred in a taxation year (the “expenditure limit”), based on the following criteria:

- A full enhanced credit is available if the taxable income in the previous taxation year of the particular corporation or the associated group is $500,000 or less.
- $10 of the expenditure limit is lost (thereby eroding the enhanced credit) for every dollar of taxable income in the previous taxation year in excess of $500,000. The expenditure limit is reduced to zero if that taxable income exceeds $800,000.

The enhanced credit is also eroded if the corporation’s (or the group’s) “taxable capital employed in Canada” (essentially the aggregate of equity and debt) exceeds $10,000,000 and is eliminated if that taxable capital exceeds $50,000,000.

The Budget proposes to remove the erosion that is based on taxable income. This proposal would apply to taxation years that end on or after March 19, 2019.

Zero-Emission Vehicles

The Budget proposes to introduce a temporary enhanced first-year CCA rate of 100 per cent in respect of eligible zero-emission vehicles. These vehicles will be classified under one of two new CCA classes.

Class 54 will include zero-emission vehicles that would otherwise be included in Class 10 or 10.1. The amount on which CCA can be claimed is limited to a maximum of $55,000 plus sales taxes, per vehicle. Class 55 will include zero-emission vehicles that would otherwise be included in Class 16.

This measure will apply to eligible zero-emission vehicles acquired on or after March 19, 2019, and that become available for use before 2028, subject to a phase-out for vehicles that become available for use after 2023. The taxpayer must claim the enhanced CCA for the taxation year in which the vehicle first becomes available for use.

The Budget proposes to amend the GST/HST rules to ensure consistency with these measures.

Character Conversion Transactions — Converting Income to Capital Gains

Capital gains are taxed at half the rate of regular income and typically at a substantially lower rate than dividend income. Consequently, where a choice is available without a change in risk, investors have a bias to earn capital gains.

Over the years financial institutions have developed products to convert something that would otherwise be regular income into a capital gain. The Department of Finance made changes to address this in 2013. The mutual fund industry since then has designed new products that aim to accomplish the same goal. The Budget proposes changes aimed at shutting down these new products.

PERSONAL MEASURES

Employee Stock Options

Employee stock options can receive preferential tax treatment. The employee has a taxable employment benefit equal to the excess of the fair market value of the shares acquired at the exercise date over the price paid under the option. If certain conditions are met, the employee will be eligible for deduction of half the benefit effectively making the benefit half-taxable.

The Budget indicates the government's intention to limit this preferential treatment (presumably the deduction for half the benefit). Specifically, the preferential treatment will only be available on shares acquired that fall under a cap for the year of grant. An annual cap of $200,000 has been set based on the fair market value of the shares that are the subject of the option. The Budget is silent on the date that the FMV is determined. It is intended that these changes would apply to employees of "large, long-established, mature firms." Employees of start-up and rapidly growing businesses would be exempt from these rules.

The Budget indicates that further details would be released before the summer. The Budget papers do not include a proposed implementation date but do indicate that any new measures would not apply to options granted before the announcement of legislative proposals to implement any new regime.

RRSP Home Buyer's Plan

Under the RRSP Home Buyer's Plan (HBP), a first-time home buyer can borrow up to $25,000 from their RRSP to help finance the purchase or construction of a home. In order to qualify as a first-time home buyer, neither the individual nor their spouse can have owned a home in the year or any of the four preceding years. The four-year requirement is waived where the purchase is for a more accessible or suitable home that will be occupied by an individual eligible for the disability credit.

The Budget proposes to increase the maximum withdrawal per individual to $35,000 effective for withdrawals made after March 19, 2019.

The Budget also modifies the HBP rules to better accommodate marital breakdowns. The individual must be living separate and apart from their spouse, including a common-law partner, for a period of at least 90 days. The individual will be eligible to make a HBP withdrawal if the spouses live separate and apart at the time of the withdrawal and began to live separate and apart in the year of withdrawal or at any time in the four preceding years. However, if the individual is living in a home owned by a new spouse, they will not be able to use the HBP. This measure is effective after 2019.

Canada Training Credit

The Budget introduces the refundable Canada Training Credit (CTC). It is intended to provide financial support for professional development and training for working Canadians age 25 to 65. Eligible individuals will accumulate $250 per annum in a notional account which can be used to cover eligible training costs. The annual accumulation will start with the 2019 taxation year, with 2020 being the first year the CTC can be claimed.

In order to accumulate the $250 for a year, the individual must be age 25 to 64 at the end of the year, resident in Canada for the entire year, file a tax return for the year, have qualifying "working" income in the year of at least $10,000 (to be indexed annually) and have net income for tax purposes for the year of no more than the top of the third tax bracket for the year ($147,667 for 2019, indexed annually). Qualifying income includes employment income, self-employment income, maternity/parental Employment Insurance benefits and similar items. The $250 is still accumulated for years in which the CTC is claimed.

The amount of CTC that can be claimed will be the lesser of one-half of the eligible tuition and fees paid in respect of the year (generally those eligible for the tuition credit except that the educational institution must be in Canada) and the accumulated account balance at the beginning of the year. The individual will be able to claim the tuition credit on the eligible tuition and fees net of the CTC claimed. The individual must be resident in Canada throughout the year to be able to claim the CTC.

Digital Subscriptions Tax Credit

The Budget proposes a 15 per cent non-refundable tax credit on up to $500 of costs for eligible digital subscriptions per annum, resulting in a maximum $75 annual credit. To be eligible, the amounts must be paid to a Qualified Canadian Journalism Organization (QCJO) for a subscription to digital form content of a QCJO. The QCJO must be primarily engaged in producing written content. A subscription with a broadcaster will not qualify. The credit will be available for amounts paid after 2019 and before 2025.

Change in Use Rules for Multi-Unit Residential Properties

A taxpayer is deemed to have disposed of a property, or a part thereof, when its use is converted from income-earning to personal use, or vice versa. Under current rules, where the use of an entire property is converted to income-earning, or an income-earning property becomes a taxpayer’s principal residence, the taxpayer may elect to not have the deemed disposition occur in order to defer the taxation of any accrued capital gain until the time that the property is sold. In cases where only part of a property is converted, this election is unavailable.

The Budget proposes to extend the above-mentioned election to situations where only part of a property undergoes a change in use. For example, where a taxpayer owns a multi-unit residential property such as a triplex, if the taxpayer begins to live in one of the units previously rented, or vice versa, he or she can elect to not have the deemed disposition occur to that unit.

This measure will apply to changes in use that occur on or after March 19, 2019.

Medical Expense Tax Credit

Amounts paid for cannabis products may be eligible for the medical expense tax credit where such products are purchased for a patient for medical purposes in accordance with the regulations under the Controlled Drugs and Substances Act. As of October 17, 2018, cannabis is no longer regulated under this Act, but rather is subject to the Cannabis Regulations under the Cannabis Act.

The Budget proposes to amend the *Income Tax Act* to reflect the current regulations for accessing cannabis for medical purposes. This measure will apply to expenses incurred on or after October 17, 2018.

REGISTERED PLANS AND PENSION PLANS

Registered Disability Savings Plans

A Registered Disability Savings Plan (RDSP) is a vehicle intended to assist a family in providing for the long-term financial security of a family member eligible for the disability tax credit (DTC). There are special rules that apply where the beneficiary for whom the RDSP was established ceases to be eligible for the DTC.

Currently, when DTC eligibility ceases, no further contributions to the RDSP can be made and no further Canada disability savings grants and bonds can be paid into the plan. The RDSP must be collapsed by the end of the first year following the first full year of DTC ineligibility, unless an election is made to extend the RDSP's life. The life can be extended for four years if a medical practitioner certifies in writing that the beneficiary will once again become eligible for the DTC in the foreseeable future. During the election period, no further contributions can be made or grants received, but withdrawals can be made under the normal rules.

The Budget proposes to relax these rules for 2021 and later years. The life of the RDSP will be able to be extended indefinitely and the requirement for medical practitioner certification eliminated. A rollover of a deceased individual's RRSP or RRIF to the RDSP of a financially dependent infirm child or grandchild will be permitted, as long as the rollover occurs by the end of the fourth calendar year following the first full year of DTC ineligibility.

RDSPs will not be required to be collapsed after March 18, 2019, and before 2021 solely because the beneficiary has become ineligible for the DTC.

Carrying on Business in a Tax-Free Savings Account (TFSA)

A Tax-Free Savings Account (TFSA) is liable to pay tax under Part I of the *Income Tax Act* (at the top personal rate) on income from a business carried on by the TFSA or from non-qualified investments. Under the current rules, the trustee of the TFSA (i.e., a financial institution) is jointly and severally liable with the TFSA for Part I tax.

The Budget proposes to extend the joint and several liability for that tax owing on income from carrying on a business in a TFSA to the holder of the TFSA. The joint and several liability of a trustee of a TFSA at any time in respect of business income earned by a TFSA will be limited to the property held in the TFSA at that time plus the amount of all distributions of property from the TFSA on or after the date that the notice of assessment is sent. This measure will apply to the 2019 and subsequent taxation years.

Individual Pension Plans

Individual Pension Plans (IPPs) are defined-benefit pension plans that are intended to be an alternative to an RRSP for providing retirement benefits to the owner-manager. When an individual terminates membership in a defined-benefit pension plan, such as on termination of employment, a tax-deferred transfer of the commuted value of the member's pension benefits is allowed. 100 per cent of the commuted value may be transferred to another defined-benefit plan or a prescribed portion (usually around 50 per cent) may be transferred to an RRSP.

Because of the greater amount that may be transferred to a registered pension plan (RPP), planning has developed making use of IPPs to circumvent the RRSP limitation. A new company is incorporated by the former plan member. This new company establishes an IPP to which the commuted value of the former pension benefits is transferred. The new company generally has no other purpose or activity.

The government considers this type of planning to be inappropriate. Accordingly, the Budget proposes that IPPs not be able to provide retirement benefits in respect of years of service under a defined-benefit plan of other than the company (or its predecessor) that established the IPP. Furthermore, assets transferred from a former employer's defined benefit plan to an IPP that relate to such service will be required to be included in the income for tax purposes of the former plan member.

These measures are to apply to pensionable service credited under an IPP on or after March 19, 2019.

Permitting additional types of annuities under registered plans

The Budget proposes to permit two new types of annuities to be purchased under certain registered plans, subject to specified conditions.

Firstly, "advanced life deferred annuities" (ALDAs) will be permitted, within limits, under a registered retirement savings plan, registered retirement income fund, deferred profit-sharing plan, pooled registered pension plan (PRPP), and defined-contribution registered pension plan.

An ALDA is a life annuity whose commencement is deferred until the end of the year in which the annuitant turns 85.

Secondly, "variable payment life annuities" (VPLAs) will be permitted under a PRPP and defined-contribution RPP.

A VPLA is a life annuity whose payments vary based on the investment performance of the underlying annuities fund and the mortality experience of VLPA annuitants.

These measures will apply to the 2020 taxation year and beyond.

INTERNATIONAL TAX MEASURES

Transfer Pricing

Order of application of transfer-pricing rules

Transfer-pricing rules in the *Income Tax Act* generally provide that, where a Canadian taxpayer transacts with non-arm's-length parties outside Canada, the price used for the transaction must be established using the arms'-length principle. That is, the parties must establish a price that is within the range that arms'-length third parties would have used had they transacted under the same terms and conditions.

The *Income Tax Act* contains other provisions which may require adjustment to the income reported on a transaction. Questions arose regarding whether adjustments were made pursuant to general transfer-pricing rules or other more specific provisions. In these situations, it was not clear whether transfer-pricing penalties were applicable.

The Budget proposes that the transfer-pricing adjustments shall apply in priority to any other adjustments required under the *Act*. Presumably, any applicable transfer-pricing penalties will apply in these situations.

Current exceptions to the transfer-pricing rules (for example subsection 17(8) which permits certain zero or low interest loans made to controlled foreign affiliates) are retained.

This measure applies to taxation years commencing after March 19, 2019.

Reassessment period for transfer-pricing "transactions"

The definition of "transaction" for transfer-pricing purposes is expanded beyond the normal meaning of that word.

The *Income Tax Act* provides an extended three-year reassessment period beyond the usual reassessment period for transfer-pricing adjustments. However, the definition of "transaction" for reassessment purposes was not the expanded definition used for transfer-pricing purposes. The Budget proposes to use the expanded definition of "transaction" in determining whether that transaction can be reassessed in the extended three-year reassessment period.

This measure applies to taxation years for which the normal reassessment period ends on or after March 19, 2019, meaning it applies to most transactions that have occurred in the last three to four years.

SALES TAX AND EXCISE TAX MEASURES

Foot-Care Devices Supplied by Order of a Podiatrist or Chiropodist

Certain foot care devices, such as orthopedic devices and anti-embolic stockings, are zero-rated and relieved from GST/HST when supplied on the written order of a physician, nurse, physiotherapist or occupational therapist. The Budget proposes to add licensed podiatrists and chiropodists to the list of practitioners on whose order supplies of foot-care devices are zero-rated.

This measure will apply to supplies of foot-care devices made after March 19, 2019.

Multidisciplinary Health-Care Services

Health-care services may be provided by a multidisciplinary health team of licensed health-care professionals consisting of a physician, an occupational therapist and a physiotherapist. When supplied separately, the services rendered by these health-care professionals would generally be exempt from GST/HST. Currently, there is no GST/HST provision that explicitly relieves the service of a multidisciplinary team that combines elements of the various practices.

The Budget proposes to exempt from the GST/HST, the supply of a service rendered by a team of health professionals, such as doctors, physiotherapists and occupational therapists, whose services are GST/HST-exempt when supplied separately. The exemption will apply where all or substantially all of the service is rendered by such health professionals acting within the scope of their profession.

This measure applies to supplies of multidisciplinary health services made after March 19, 2019.

Cannabis Taxation

Later this year, edible cannabis, cannabis extracts and cannabis topicals will be permitted for legal sale under the *Cannabis Act*. The Budget proposes to impose excise duties on these products (including cannabis oils) based on the quantity of tetrahydrocannabinol (THC) contained in the final product. The THC-based duty will be imposed at the time of packaging of a product and become payable when it is delivered to a non-cannabis licensee such as a provincial wholesaler, retailer or individual consumer.

The combined federal-provincial territorial THC-based excise duty rate for cannabis edibles, cannabis extracts (including cannabis oils) and cannabis topicals is proposed to be $0.01 per milligram of total THC.

This measure will come into effect on May 1, 2019, subject to certain transitional rules.

PREVIOUSLY ANNOUNCED INCOME TAX MEASURES

Budget 2019 confirms the government's intention to proceed with previously announced income tax measures. Some of the key measures are summarized below.

Measures from the Fall Economic Statement

In its November 21, 2018, Fall Economic Statement, the government announced several income tax measures.

Accelerated Investment Incentive

The Accelerated Investment Incentive was introduced to allow businesses in Canada that acquire capital property on or after November 21, 2018, but before 2028, to be eligible for an enhanced first-year CCA deduction. This incentive will not apply to Classes 53, 43.1, and 43.2, which will instead be eligible for full expensing as discussed below.

To qualify for the incentive, the property cannot have been previously owned by the taxpayer or a non-arm's-length person, nor can it be transferred to the taxpayer on tax-deferred "rollover" basis.

In the year that a capital asset becomes available for use, the taxpayer will be able to deduct three times the CCA that would have been deductible in the absence of this measure. The mechanics to achieve this result entail the suspension of the half year rule and the application of 1.5 times the CCA rate that would have otherwise applied (i.e., twice the CCA base multiplied by 1.5 times the CCA rate is equal to 3 times the CCA deduction). The larger deduction in the first year is ultimately offset by smaller deductions in the future years.

This measure will be phased out for capital assets that become available for use after 2023, as follows.

For capital property that would normally be subject to the half-year rule and becomes available for use between 2024 and 2027, the half-year rule will still be suspended, but the normal CCA rate will apply. The result is twice the CCA deduction in the first year.

For capital property that would not normally be subject to the half-year rule, the enhanced CCA deduction will be equal to 1.25 times the normal first year deduction.

Full expensing for manufacturing and processing equipment

Canadian businesses will be able to deduct 100 per cent of the cost of machinery and equipment acquired on or after November 21, 2018, that is used to manufacture and process goods in Canada.

A phase-out will begin for assets that become available for use in 2024, where the first-year deduction is reduced to 75 per cent. In 2026, the first-year deduction is further reduced to 55 per cent. For assets that become available for use after 2027, this measure will not apply.

To qualify for the enhanced write-off, the asset cannot have been previously owned by the taxpayer or a non-arm's-length person, nor can it be transferred to the taxpayer on tax-deferred "rollover" basis.

Full expensing for clean energy equipment

Specified clean energy equipment acquired on or after November 21, 2018, will be eligible for a 100 per cent deduction in the year that the asset becomes available for use in a business.

This measure will phase out in the exact same manner as the phase-out of the full expensing for manufacturing and processing equipment discussed above.

To qualify for the enhanced write-off, the asset cannot have been previously owned by the taxpayer or a non-arm's-length person, nor can it be transferred to the taxpayer on a tax-deferred "rollover" basis.

Extension of mineral exploration tax credit

The 15 per cent Mineral Exploration Tax Credit is extended from March 31, 2019, to March 31, 2024. This credit applies to specified mineral exploration expenses incurred in Canada and renounced by a corporation to individual flow-through share investors.

Trusts — Reporting Requirements

Budget 2018 proposed extensive new reporting requirement for most family trusts, effective for returns required to be filed for 2021 taxation years.

Intergenerational Business Transfers

The government will continue its initiative to develop new proposals to ensure that intergenerational transfers of businesses are better accommodated under the tax system. Budget 2019 specifically mentions Canadian farmers and fishers, but adds that this initiative also applies to other types of business owners.