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2019 Federal Budget: Tax Highlights

Authors: [Brian Bloom](#), [Marie-Emmanuelle Vaillancourt](#), [Elie Roth](#), [Michael N. Kandeve](#), [Paul Lamarre](#), [Christopher Anderson](#), [Sharon Ford](#), John J. Lennard and Ryan Abrahamson

Budget 2019 is the last federal budget of the current Liberal government before the upcoming federal election in October 2019. Tax-related measures are intended to advance the government's stated priority of creating a fair tax system. Proposals include changes to the employee stock option rules, rules affecting allocations by mutual fund trusts, new limitations on character conversion transactions and technical amendments to certain international tax rules that, among other things, expand the application of the foreign affiliate dumping rules and modify the application of the transfer pricing rules.

The principal tax changes announced in Budget 2019 of interest to the business community are summarized below.

Income Tax Measures

Employee Stock Options

Budget 2019 proposes to limit the use of employee stock options for employees of certain corporations. Under the existing rules, employees who are issued stock options are able to access preferential personal income tax treatment (50% of ordinary tax rates) on qualifying stock option benefits. The proposals would impose a \$200,000 annual cap on employee stock option grants, based on the fair market value of the underlying shares at the time of the grant, for employees of "large, long-established, mature firms." For example, if an employee of such a corporation receives a stock option grant to acquire 100,000 shares at a price of \$50 per share (being the fair market value of the shares at the time of the grant), the preferential tax treatment would be available only with respect to options to acquire 4,000 (\$200,000 divided by \$50) shares. The stock option benefit associated with the options to acquire the remaining 96,000 shares would be taxed at ordinary rates.

The Budget does not provide any details on what will constitute a "large, long-established, mature firm," other than to note that employee stock option benefits will remain uncapped for startups and rapidly growing Canadian businesses.

The Budget materials do not contain draft legislation for these proposals, but indicate that full details will be released before the summer of 2019. Changes would apply on a "go-forward basis" and would not apply to employee stock options granted prior to the announcement of legislative proposals.

Mutual Fund Trusts: Allocation to Redeeming Unitholders

A mutual fund trust is taxed on its investment income, but can obtain a deduction to the extent that it distributes its income or capital gains to unitholders, who will then be taxed on the allocated income or capital gains. If a mutual fund trust disposes of investments in order to fund redemptions by unitholders, the accrued gain on investments can potentially give rise to double taxation: once at the mutual fund trust level and again in hands of the redeeming unitholders whose units will reflect the accrued gain on the investments. Consequently, many mutual fund trusts employ an "allocation to redeeming unitholders methodology" to eliminate double taxation by allocating capital gains to redeeming unitholders. A redeeming unitholder's capital gain on the redemption of units is generally equal to the proceeds received minus the amount of capital gains allocated by the trust. Accordingly, if the mutual fund trust allocates a capital gain to redeeming unitholders equal to the amount of capital gain that would otherwise be realized on the redemption, the redeeming unitholders would be in the same position as if they had sold their units for fair market value, but the mutual fund trust would be entitled to a deduction, thereby avoiding the double tax impact that could otherwise arise.

The Department of Finance suggests that certain mutual fund trusts have allocated capital gains to redeeming unitholders in excess of the amount that the redeeming unitholders would otherwise have realized on a disposition of their units. In such a circumstance, the mutual fund trust was entitled to a deduction for the full amount of capital gains that were allocated to the redeeming unitholder. However, the redeeming unitholder would not be subject to additional tax on the redemption, as the excess capital gains that were allocated by the mutual fund trust would be offset by an additional capital loss realized by the unitholder on the disposition. The Department of Finance believes that this result is inappropriate. Budget 2019 includes rules to limit the amount of capital gains that can be allocated to a redeeming unitholder to the amount of capital gain the redeeming unitholder would otherwise realize on the redemption of units.

Budget 2019 also includes rules that apply to redemptions of units held by investors on income account. If a mutual fund trust allocates more income and less capital gains to a holder that holds units on income account, the holder would not be adversely affected from a tax perspective because the holder would realize an income gain on the disposition of the units in any event, but the remaining holders who hold their units on capital account would realize a benefit since they could be allocated additional capital gains and less income. Budget 2019 proposes to deny the deduction for mutual fund trusts that allocate income to a redeeming unitholder if the allocated amount is ordinary income and the redemption proceeds are reduced by the allocation.

The above measures apply to taxation years of mutual fund trusts beginning on or after March 19, 2019 (Budget Day).

Character Conversion Transactions

Budget 2013 introduced the “derivative forward agreement” rules that were generally intended to ensure that taxpayers did not use derivative transactions to convert ordinary income into capital gains. Generally speaking, a derivative forward agreement is an agreement to purchase capital property where the agreement has a term of more than 180 days and the difference between the fair market value of the property delivered on settlement of the agreement and the amount paid for the property is attributable to an underlying interest (such as interest rate, a commodity price, etc.). The derivative forward agreement rules do not apply to an agreement if the price paid for property depends on the fair market value of the property itself (which is described as the “commercial transaction exception”).

Budget 2019 indicates that the commercial transaction exception has been used in transactions involving a series of mutual fund trusts and derivative agreements that the Department of Finance believes inappropriately circumvent the derivative forward agreement. Consequently, Budget 2019 introduces an additional provision to the derivative forward agreement rules, which will provide that the commercial transaction exception does not apply to an agreement to purchase a security if it can reasonably be considered that one of the main purposes of the series of transactions that includes the agreement is to convert an amount that would otherwise be income into a capital gain.

This measure will apply to transactions entered into on or after Budget Day. For taxation years beginning after December 2019, the measure will also apply to transactions entered into before Budget Day that are extended or renewed after Budget Day.

Carrying on Business in a TFSA

Although investment income earned in a TFSA is not subject to tax, a TFSA is liable to pay tax at the highest personal tax rate on income from a business carried on by the TFSA. Under the current rules, the trustee of a TFSA is jointly and severally liable with the TFSA for this tax. The Budget proposes to extend this liability to the TFSA holder and to limit the trustee's liability to the property held in the TFSA and distributions made after the date on which a notice of assessment is issued.

This measure will be applicable beginning in 2019.

International Tax Measures

Update on the Base Erosion and Profit Shifting Project

Budget 2019 reiterates the government's commitment to the OECD's Base Erosion and Profit Shifting initiative, provides a brief update on the administration and information exchange of country-by-country reports prepared by large multinationals and confirms that the

government is taking the necessary steps to enact the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which is expected to be ratified in 2019.

Transfer Pricing

Pursuant to Canada's transfer pricing rules, where the terms or conditions of a cross-border transaction or series of transactions between non-arm's-length persons do not reflect arm's-length terms and conditions, the Minister may adjust the quantum or nature of the relevant amounts to reflect arm's-length terms and conditions. Other provisions of the *Income Tax Act* (Canada) (ITA) also apply to adjust the Canadian tax consequences of transactions between non-arm's-length persons. Budget 2019 proposes to amend the ITA so that the transfer pricing rules take priority over such other provisions.

This proposal will apply to taxation years that begin on or after Budget Day. Notably, the current exceptions to the application of the transfer pricing rules that pertain to situations in which a Canadian resident corporation has an amount owing from, or extends a guarantee in respect of an amount owing by, a controlled foreign affiliate will continue to apply.

In addition, Budget 2019 proposes to extend the normal reassessment period (generally three or four years) by an additional three years for transactions caught by the transfer pricing rules. This measure will apply to taxation years for which the normal reassessment period ends on or after Budget Day.

Foreign Affiliate Dumping

The foreign affiliate dumping rules are a complex set of provisions in the ITA that apply when a corporation resident in Canada (CRIC) that is controlled by a non-resident corporation makes or is deemed to make an investment in a foreign affiliate. When applicable, the foreign affiliate dumping rules deem a dividend to be paid by the CRIC to the controlling non-resident corporation equal to the amount of the investment in the foreign affiliate unless the CRIC elects to reduce the paid-up capital of its shares. Budget 2019 proposes to extend the application of these rules to CRICs that are controlled by a non-resident individual, a non-resident trust or a group of such persons or non-resident corporations that do not deal with each other at arm's length.

This measure will apply to transactions and events that occur on or after Budget Day.

Cross-Border Share Lending Arrangements

The ITA contains rules that generally seek to put a lender under a securities lending arrangement in the same tax position as if the securities had not been loaned. Where a non-resident loans a share to a Canadian resident, these rules deem a dividend compensation payment made under a "fully collateralized" arrangement to be a dividend payable on the loaned share. This deemed dividend is subject to Canadian dividend withholding tax. If a securities lending arrangement is not fully collateralized, the dividend compensation payment is instead deemed to be a payment of interest made by the Canadian resident to the non-resident. Interest paid to a non-resident with whom a Canadian resident is dealing at arm's length is generally exempt from Canadian withholding tax.

Budget 2019 notes that certain non-residents have engaged in planning intended to avoid Canadian dividend withholding tax on dividend compensation payments made to them in respect of shares of Canadian resident corporations by avoiding the fully collateralized test or otherwise circumventing the "securities lending arrangement" definition in the ITA.

Budget 2019 proposes an amendment to ensure that a dividend compensation payment made under a securities lending arrangement by a Canadian resident to a non-resident in respect of a Canadian share is treated as a dividend and subject to Canadian dividend withholding tax.

Budget 2019 also proposes an amendment to apply the characterization rules not only to a securities lending arrangement but also to a "specified securities lending arrangement." Budget 2018 introduced the latter definition in the context of a measure intended to prevent taxpayers from realizing artificial losses through the use of equity-based financial arrangements.

The securities lending arrangement rules may also inappropriately subject dividend compensation payments in respect of shares of non-resident corporations to Canadian dividend withholding tax. To address this issue, Budget 2019 exempts such dividend compensation payments from Canadian dividend withholding tax.

These proposed amendments will generally apply to compensation payments made on or after Budget Day.

Donations of Cultural Property

Budget 2019 proposes to remove the requirement that property be of “national importance” in order to qualify for the tax incentives pertaining to donations of cultural property. This change is in response to a recent decision of the Federal Court (*Heffel Gallery*) in which the Court narrowly interpreted “national importance” to mean that the particular property has a direct connection with Canada’s heritage. The proposed amendments to the ITA and the *Cultural Property Export and Import Act* (Canada) clarify that the types of property that may qualify for the tax credit include foreign works of art that do not have a direct connection with Canada’s heritage.

This measure will apply in respect of donations made on or after Budget Day.

Personal Tax Measures

Budget 2019 also proposes a number of personal tax measures, including the following:

- Increasing the withdrawal limit from RRSPs for first-time homebuyers from \$25,000 to \$35,000.
- Providing a taxpayer with the ability to elect that a deemed disposition does not occur on a change in use of part of a multi-unit residential property to provide consistent tax treatment with the change in use provisions pertaining to single-unit residential properties.
- Introducing the Canadian Training Credit, a refundable tax credit designed to finance up to 50% of eligible tuition and fees associated with training. Eligible individuals will accumulate \$250 per year in a notional account, subject to a \$5,000 lifetime limit, to claim the credit.
- Permitting the Canada Revenue Agency to send requirements for information to banks and credit unions by electronic means.

Excise Tax Measures

Cannabis Tax

Currently, only fresh and dried cannabis, cannabis oil and cannabis plants and seeds can be sold in Canada under the *Cannabis Act* (Canada), but cannabis edibles, extracts and topicals will become legal for sale in 2019. Budget 2019 contains proposals for the taxation of these new products, as well as cannabis oils, under the *Excise Act, 2001* (Canada), based on the quantity of tetrahydrocannabinol, or THC, in the final product at the time of packaging. These proposals are intended to simplify the excise duty calculation and generally ease compliance issues for these cannabis products. The proposed measures will come into effect on May 1, 2019, and will not otherwise affect the current excise tax regime for cannabis.

Key Contacts: [R. Ian Crosbie](#), [Elie Roth](#), [Paul Lamarre](#), [Christopher Anderson](#), [Brian Bloom](#), [Marie-Emmanuelle Vaillancourt](#) and [Michael N. KandeV](#)

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