2019 Federal Budget Review

On March 19, Finance Minister Bill Morneau unveiled the Liberal Government's fourth Federal Budget – and final budget before the 2019 election. Entitled "Investing in the Middle Class", Budget 2019 continues with many of the themes of previous Liberal budgets, and anticipates a deficit of $19.8 billion for fiscal 2019-20 and $19.7 billion in 2020-21.

The key themes of the Budget include (i) Housing: increasing supply, improving fairness, and reducing barriers to home ownership by enhancing access to the Home Buyers' Plan and introducing the First Time Home Buyer Incentive, which provides lower borrowing costs through a shared equity mortgage with the Canada Mortgage and Housing Corporation; (ii) Training: assistance with the cost of post-secondary education, enhancing access to Employment Insurance for training leaves and the introduction of a new non-taxable Canada Training Credit; (iii) Pharmacare: creating the Canadian Drug Agency to decrease the high costs of prescription drugs and provide more consistent coverage; and (iv) Secure retirement: increasing the Guaranteed Income Supplement earnings exemption threshold, encouraging the take-up of the Canada Pension Plan retirement pension for contributors who haven't applied for their CPP pension by age 70, and introducing additional annuity options in registered plans. Finally, as in prior years, tax fairness and integrity remain a key theme of the Government, with several measures aimed at improving the efficiency, certainty and fairness of the tax system.

From a personal and small business tax perspective, which is the focus of this review, the Budget did not propose any changes to personal or corporate tax rates. Notable personal tax measures proposed in the Budget include the introduction of additional annuity options for registered plans, restrictions on certain transfers of commuted pension values to Individual Pension Plans, and a proposed future annual cap of $200,000 on employee stock option grants that would receive the current tax-preferred treatment. There were also limited measures affecting charitable giving and unlike recent budgets, there were only minor proposals affecting Canadian small businesses. The most significant income tax measures affecting individuals and Canadian private companies are summarized below.

Note that the measures introduced are only proposals at this stage and may not ultimately be enacted into law. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.

Summary of Personal Income Tax Proposals

Canada Training Credit

In order to encourage Canadians to enhance their skills to succeed in today's marketplace, Budget 2019 proposes to introduce the Canada Training Credit to address barriers to professional development for working Canadians. This new refundable tax credit aims to provide financial support to help cover up to half of eligible tuition and fees associated with training. Eligible individuals between the ages of 25 to 64 can accumulate $250 each year in a notional account, to a lifetime limit of $5,000, which can be accessed for this purpose.

In order to qualify, the individual must have earnings of at least $10,000 in the year and their net income for the year cannot exceed the top of the third (federal) tax bracket for the year ($147,667 in 2019). The amount of a credit that can be claimed for a taxation year will be equal to the lesser of half of the eligible tuition and fees paid in respect of the taxation year and the individual's notional account balance for the taxation year (based on amounts used or accumulated in respect of previous years). The amount claimed will offset, dollar for dollar, tax otherwise payable or will be refunded to the individual to the extent that the amount exceeds tax otherwise payable.

This measure will apply to the 2019 and subsequent taxation years. Consequently, the annual accumulation to the notional account will start based on eligibility in respect of the 2019 taxation year and the credit will be available to be claimed for expenses in respect of the 2020 taxation year.

Earning and income thresholds under the Canada Training Credit will be subject to annual indexation.

Home Buyers' Plan Enhancements

Currently, the Home Buyers' Plan (HBP) helps first-time home buyers save for a down payment by allowing them to withdraw up to $25,000 from a Registered Retirement Savings Plan (RRSP) to purchase or build a home without having to pay tax on the withdrawal. Amounts withdrawn under the HBP must be repaid to an RRSP over a period not exceeding 15 years, starting the second year following the year in which the withdrawal was made.

For HBP purposes, an individual is not considered to be a first-time home buyer if, in the relevant calendar year (or in any of the four preceding calendar years), the individual, or the individual's spouse or common-law partner, owned and occupied another home which was their principal place of residence.

In order to provide first-time home buyers with greater access to their RRSPs to purchase or build a home, Budget 2019 proposes to increase the HBP withdrawal limit to $35,000 from $25,000. As a result, a couple will potentially be able to withdraw $70,000 from their RRSPs to purchase a first home or a new home.

Budget 2019 also proposes to extend access to the HBP in order to help Canadians maintain homeownership after the breakdown of a marriage or common-law partnership. This measure will apply to HBP withdrawals made after 2019, whereas the increase in the HBP withdrawal limit will apply to the 2019 and subsequent calendar years in respect of withdrawals made after Budget Day.

Multi-Unit Residential Properties – Change In Use Rules

The *Income Tax Act* deems a taxpayer to have disposed of, and reacquired, a property when the taxpayer converts the property from an income-producing use (e.g., a rental property) to a personal use (e.g., a residential property) or *vice versa*. Where the use of an entire property is changed to an income-producing use, or an income-producing property becomes a principal residence, the taxpayer may elect that this deemed disposition not apply. As a consequence, the election can provide a deferral of the realization of any accrued capital gain on the property until it is realized on a future disposition.

The deemed disposition also occurs when the use of part of a property is changed. For example, this can occur where a taxpayer owns a multi-unit residential property, such as a duplex, and either starts renting or moves into one of the units. However, under the current rules, a taxpayer cannot elect out of the deemed disposition that arises on a change in use of *part* of a property.

To improve the consistency of the tax treatment of owners of multi-unit residential properties in comparison to owners of single-unit residential properties, Budget 2019 proposes to allow a taxpayer to elect that the deemed disposition that normally arises on a change in use of part of a property, not apply.

This measure will apply to changes in use of property that occur on or after Budget Day.

Registered Plans – Annuities

The tax rules allow funds from certain registered plans to be used to purchase an annuity to provide income in retirement, subject to specified conditions. In exchange for a lump-sum amount of funds, an annuity provides a stream of periodic payments to an individual (i.e., the annuitant), generally for a fixed term, for the life of the annuitant or for the joint lives of the annuitant and the annuitant's spouse or common-law partner.

To provide Canadians with greater flexibility in managing their retirement savings, Budget 2019 proposes to permit two new types of annuities under the tax rules for certain registered plans:

- advanced life deferred annuities (ALDAs) will be permitted under a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Deferred Profit Sharing Plan (DPSP), Pooled Registered Pension Plan (PRPP) and defined contribution Registered Pension Plan (RPP); and
- variable payment life annuities (VPLAs) will be permitted under a PRPP and defined contribution RPP.

Advanced Life Deferred Annuities

The tax rules generally require an annuity purchased with registered funds to commence by the end of the year in which the annuitant attains 71 years of age. Conversely, an ALDA will be a life annuity, the commencement of which may be deferred until the end of the year in which the annuitant attains 85 years of age. Budget 2019 proposes to amend the existing tax rules to permit an ALDA to be a qualifying annuity purchase, or a qualified investment, under the registered plans noted above; however specific limits relative to the particular qualifying plan and a comprehensive lifetime dollar limit (set initially at $150,000) for all qualifying plans will apply.

Variable Payment Life Annuities
The existing tax rules generally require that retirement benefits from a PRPP or defined contribution RPP be provided to a member by means of a transfer of funds, either from: i) the member's account to an RRSP or RRIF of the member; ii) variable benefits paid from the member's account; or iii) an annuity purchased from a licensed annuities provider. However, in-plan annuities (annuities provided to members directly from a PRPP or defined contribution RPP) are generally not permitted under the tax rules.

Budget 2019 proposes to amend the tax rules to permit PRPPs and defined contribution RPPs to provide a variable payment life annuity (VPLA) to members *directly* from the plan. A VPLA will provide payments that vary based on the investment performance of the underlying annuities fund and on the mortality experience of VPLA annuitants.

These measures will apply to the 2020 and subsequent taxation years.

Registered Disability Savings Plans

Change in Eligibility for the Disability Tax Credit
The Registered Disability Savings Plan (RDSP) is a tax-assisted savings vehicle intended to help an individual with a disability – and the individual's family – save for the individual's long-term financial security. An RDSP may be established only for a beneficiary who is eligible for the disability tax credit (DTC).

To encourage long-term saving, the Government of Canada supplements private RDSP contributions with Canada Disability Savings Grants and provides Canada Disability Savings Bonds under the Canada Disability Savings Program. These grants and bonds are eligible to be paid into an RDSP until the end of the year in which a beneficiary of the RDSP turns 49 years of age.

Currently, when a beneficiary of an RDSP ceases to be eligible for the DTC, no further contributions may be made to, and no further Canada Disability Savings Grants and Canada Disability Savings Bonds may be paid into, the RDSP. The income tax rules generally require that the RDSP be closed by the end of the year following the first full year throughout which the beneficiary is not eligible for the DTC.

Previous amendments to the *Income Tax Act* allow an RDSP plan holder to elect to extend the period for which an RDSP may remain open after a beneficiary becomes ineligible for the DTC. To qualify for this extension, a medical practitioner must certify in writing that the nature of the beneficiary's condition makes it likely that the beneficiary will, because of the condition, be eligible for the DTC in the foreseeable future.

However, concerns have been raised that the requirements that an RDSP be closed and the assistance holdback amount repaid to the Government upon loss of eligibility for the DTC do not appropriately recognize the period of severe and prolonged disability experienced by an RDSP beneficiary.

Accordingly, Budget 2019 proposes to i) remove the time limitation on the period that an RDSP may remain open after a beneficiary becomes ineligible for the DTC and ii) to eliminate the requirement for medical certification that the beneficiary is likely to become eligible for the DTC in the future in order for the plan to remain open. The general rules that currently apply in respect of a period during which an election is valid will apply to an RDSP in any period during which the beneficiary is ineligible for the DTC with some modifications.

This measure will apply after 2020. An RDSP issuer will not, however, be required to close an RDSP on or after Budget Day and before 2021 solely because the RDSP beneficiary is no longer eligible for the DTC.

Creditor Protection
Unlike RRSPs, amounts held in RDSPs are not exempt from seizure by creditors in bankruptcy. To level the playing field, Budget 2019 also proposes to exempt RDSPs from seizure in bankruptcy, with the exception of contributions made in the 12 months before the filing.

Employee Stock Options

As a continued practice in undertaking a review of federal tax expenditures and the fairness of the tax system, Budget 2019 announced the Government's intent to limit the use of the current employee stock option tax regime and move toward aligning the tax treatment with that of the United States for employees of large, long-established, mature firms.

Employee stock options, which provide employees with the right to acquire shares of their employer at a designated price, are an alternative compensation method used by businesses to increase employee engagement, and promote entrepreneurship and growth. Many smaller, growing companies, such as start-ups, promote this compensation method to attract and retain talented employees by allowing them to provide a form of remuneration linked to the future success of the company.

To support this objective, current tax rules provide employee stock options with preferential personal income tax treatment in the form of a stock option deduction. This effectively results in the income tax benefit realized being taxed at a rate equal to one half of the normal personal tax rate applicable to other forms of employment income, effectively resulting in the same preferential tax rate as capital gains.

In the Budget, the Government noted that it does not believe that employee stock options should be used as a tax-preferred method of compensation for employees of large, mature companies. In light of this policy rationale, the Government intends to move forward with changes to limit the benefit of the employee stock option deduction for high-income individuals employed at large, long-established, mature firms. In its approach, the Government indicated that it will be guided by two key objectives:

1. to make the employee stock option tax regime fairer and more equitable for Canadians; and
2. to ensure that start-ups and emerging Canadian businesses that are creating jobs can continue to grow and expand.

Specifically, the Government intends to apply a $200,000 annual cap on employee stock option grants (based on the fair market value of the underlying shares) that may receive the current tax-preferred treatment for employees of large, long-established, mature firms. However, for start-ups and rapidly growing Canadian businesses, it is intended that the current tax-preferred treatment of employee stock option benefits would remain uncapped.

The Budget did not outline the distinction between the types of firms identified above, however the Government stated that further details of this measure will be released before the summer of 2019. The Budget commentary indicated that any changes would apply on a go-forward basis only and would not apply to employee stock options granted prior to the announcement of legislative proposals to implement any new regime.

Proposals Affecting Canadian Businesses

Support for Canadian Journalism

To provide support for Canadian journalism, the Budget proposes to introduce three new tax measures:

- allowing journalism organizations to register as qualified donees to access charitable tax incentives for not-for-profit journalism (beginning as of January 1, 2020);
- a 25 per cent refundable labour tax credit for qualifying journalism organizations on salary or wages paid to eligible newsroom employees (applicable beginning on January 1, 2019); and
- a temporary, 15 per cent non-refundable tax credit for up to $500 of subscriptions to Canadian digital news (available in respect of eligible amounts paid after 2019 and before 2025).

Small Business Deduction – Farmers and Fishers

Currently, certain relief is provided to Canadian-controlled private corporations (CCPCs) carrying on a farming or fishing business from tax rules designed to prevent the multiplication of the small business deduction (a deduction to reduce a CCPC's federal corporate income tax rate from 15 per cent to 9 per cent on qualifying income in 2019, up to $500,000). To provide greater flexibility to farming and fishing business, the Budget proposes to extend this relief to sales of farming products and fishing catches to any arm's length corporation, thereby broadening access to the small business deduction for these businesses.

This measure applies to taxation years that begin after March 21, 2016.

Scientific Research and Experimental Development Program (SR&ED)

Under the SR&ED tax incentive program, qualifying expenditures are fully deductible in the year they are incurred. In addition, these expenditures are eligible for an investment tax credit. The rate and level of refundability of the credit vary depending on the characteristics of the business, including its legal status and its size. For CCPCs, a fully refundable enhanced tax credit at a rate of 35 per cent is available on up to $3 million of qualifying SR&ED expenditures annually. Under the current tax law, this expenditure limit is gradually phased out based on two factors, which apply on the basis of an associated group:

- if taxable income for the previous taxation year is between $500,000 and $800,000; and
- if taxable capital employed in Canada for the previous taxation year is between $10 million and $50 million.

The Budget proposes to repeal the use of taxable income as a factor in determining the phase-out of a CCPC's annual expenditure limit for the purpose of the enhanced SR&ED tax credit. As a result, small CCPCs with taxable capital of up to $10 million will benefit from unreduced access to the enhanced refundable SR&ED credit regardless of their taxable income.

This measure will apply to taxation years that end on or after Budget Day.

Continued

Other Notable Proposals

Integrity Measures

In each of its previous three budgets, the Government has introduced tax measures intended to maintain the integrity of Canada's tax system as well as to ensure tax rules function as intended and do not result in unfair tax advantages. Budget 2019 continues this approach by proposing further integrity measures that are intended to:

- Prevent the use by mutual fund trusts of a method of allocating capital gains or income to their redeeming unitholders where the use of that method inappropriately defers tax or converts fully taxable ordinary income into capital gains taxed at a lower rate;
- Improve existing rules meant to prevent taxpayers from using derivative transactions to convert fully taxable ordinary income into capital gains taxed at a lower rate;
- Further strengthen Canada's international tax rules by refining existing measures, including an ordering rule to ensure that the transfer pricing rules (i.e., rules that apply to certain international transactions) in the *Income Tax Act* apply before other provisions of the Act; and
- Ensure fairness by extending the joint and several liability for tax owing on income from carrying on a business in a TFSA, to the TFSA holder – recognizing that TFSA holders are typically in the best position to determine whether the activities of the TFSA constitute carrying on a business.

Individual Pension Plans

A further integrity measure announced in Budget 2019 seeks to prevent Individual Pension Plans (IPPs) from avoiding the prescribed transfer limits on commuted pension values. Generally, when an individual terminates membership in a defined benefit Registered Pension Plan, income tax rules allow for a tax-deferred transfer of a prescribed portion (normally about 50 per cent) of the commuted value to the member's RRSP or similar registered plans. These limits are meant to prevent inappropriate tax deferrals when individuals transfer assets out of certain types of pension plans. The Government has become concerned with planning being undertaken that seeks to circumvent these prescribed transfer limits to obtain a 100 per cent transfer of pension assets to a new IPP (sponsored by a newly formed corporation controlled by the terminated individual) instead of the restricted transfer limits to the individual's RRSP or other registered plan. The Budget therefore proposes measures that are intended to ensure the prescribed transfer limits are not circumvented. Specifically, IPPs will be prohibited from providing retirement benefits for past years of employment that were pensionable services under a defined benefit plan of another employer other than the IPP's participating employer (or a predecessor employer). This measure applies to pensionable service credited under an IPP on or after Budget Day.

Charitable Giving

Donations of Cultural Property

Enhanced tax incentives are provided under the *Income Tax Act* to encourage donations of cultural property to certain designated institutions and public authorities in Canada, in order to ensure that such property remains in Canada for the benefit of Canadians. The enhanced tax incentives include a charitable donation tax credit (for individuals) or deduction (for corporations), which may eliminate the donor's tax liability for a year, and an exemption from income tax for any capital gains arising on the disposition.

To qualify for the incentives, a donated property must be of "outstanding significance" by reason of its close association with Canadian history or national life, its aesthetic qualities or its value in the study of the arts or sciences. In addition, it must be of "national importance" to such a degree that its loss to Canada would significantly diminish the national heritage. These requirements are set out in the *Cultural Property Export and Import Act* and are also used to regulate the export of cultural property out of Canada.

However, a recent court decision related to the export of cultural property interpreted the "national importance" test as requiring that a cultural property have a direct connection with Canada's cultural heritage. This decision has raised concerns that certain donations of important works of art that are of outstanding significance but of foreign origin may not qualify for the enhanced tax incentives.

To address these concerns, Budget 2019 proposes to amend the *Income Tax Act* and the *Cultural Property Export and Import Ac*t to remove the requirement that property be of "national importance" in order to qualify for the enhanced tax incentives for donations of cultural property. No changes are proposed that would affect the export of cultural property.

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

Previously Announced Measures

The Budget also confirms the Government's intention to proceed with certain other previously announced tax and related measures, including the following measures affecting individuals and Canadian private companies:

- The income tax measures announced on November 21, 2018 in the Fall Economic Statement which provide for accelerated capital cost allowance;
- The income tax measures announced in Budget 2018 to implement enhanced reporting requirements for certain trusts to provide additional information on an annual basis (along with new Budget 2019 measures proposing further amendments to the *Canada Business Corporations Act* to make beneficial ownership information maintained by federally incorporated corporations more readily available to tax authorities and law enforcement);
- The income tax measures announced in Budget 2018 to facilitate the conversion of Health and Welfare Trusts to Employee Life and Health Trusts; and
- Continued outreach to farmers, fishers and other business owners throughout 2019 to develop new proposals to better accommodate intergenerational transfers of businesses while protecting the integrity and fairness of the tax system.

For additional information on the above proposals originating from the 2018 Federal Budget, please see our **2018 Federal Budget Review**.

The **2019 Federal Budget Review** was developed by our in-house experts in the Wealth Planning & Advisory Services Group at BMO Wealth Management: **John Waters**, Vice-President, Director of Tax Consulting Services and **Dante Rossi**, Director, Tax Planning. For more insights, visit **bmo.com/wealthexchange**

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details.

This document is a summary of the Federal Budget and does not represent BMO Financial Group's view on the tax policies expressed in the Federal Budget.

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