TAX LETTER

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FEDERAL BUDGET HIGHLIGHTS

The Federal government presented its 2019 Budget on March 19, 2019. As usual, there were some significant income tax proposals and amendments. They included the following:

- Canada Training Benefit: The Budget introduced a new "Canada Training Benefit" refundable tax credit. This credit is meant to help people who are currently working and who wish to undertake further educational training. The structure of the credit is unique, in that individuals accumulate $250 each year in a notional account, starting 2019. In any taxation year in which you incur eligible tuition fees, you can claim a credit equal to half of the tuition fees, up to a limit of your notional account accumulated for previous years. For example, if you accumulated $250 in each of 2019 and 2020 and incurred $1,200 of tuition fees in 2021, you would get a tax credit of $500 in 2021.

  Eligible tuition fees are the same as those that qualify for the tuition tax credit, except that the educational institution must be in Canada. Tuition fees that are effectively refunded through the new credit do not qualify for the tuition tax credit, but any excess tuition fees can qualify for the tuition credit.

  In order to accumulate the $250 amount in a year, you must be at least 25 years old and less than 65 at the end of the year, with eligible earnings of $10,000 or more (this includes employment income and business income and certain other amounts), and not have net income (as reported on your return, but including income exempt for a status Indian) exceeding $147,668 for 2019.

- RRSP Home Buyers Plan: This plan currently allows individuals to withdraw up to $25,000 from a registered retirement savings account (RRSP) on a tax-free basis to buy a home, to a maximum of $50,000 per couple and with certain restrictions.

The limit is being increased to $35,000, or $70,000 per couple, for withdrawals made after March 19, 2019. The repayment period remains 15 years.

The RRSP rules were also amended to accommodate married or common-law partner couples who separate or divorce, making it easier for such individuals to re-use the Home Buyers Plan (generally, you cannot use the Plan if you or your spouse owned a home before the withdrawal or in the previous four calendar years; this rule is being relaxed somewhat for couples who split).

- <u>More flexibility for pension annuities starting in 2020:</u> Under current rules, if you wish to convert a registered plan, such as your RRSP or defined-contribution registered pension plan (RPP), into an annuity, the latest the annuity payments can start is the end of the year in which you turn 71. The Budget introduced the "advanced life deferred annuity" (ALDA), the payments under which can be deferred until the end of the year in which you turn 85. The ALDAs will be allowed under an RRSP, RPP, registered retirement income fund (RRIF), deferred profit sharing plan (DPSP), or pooled registered pension plan (PRPP). The amount in the registered plan that can be converted into an ALDA will be limited to 25% of the value of the property held in the qualifying plan as at the end of the previous year plus any amounts from the plan used to purchase ALDAs in previous years, with a lifetime limit of $150,000, to be indexed after 2020.

  The Budget also introduced new rules that will allow PRPPs and defined contribution RPPs to provide a "variable payment life annuity" (VPLA). A VPLA will provide payments that can vary, based on the performance of the underlying investments and mortality experience for VPLA annuitants.

- <u>TFSA tax on business income:</u> If your tax-free savings account (TFSA) carries on a business, it is liable to pay tax on the income from the business. (For example, the CRA may assess a TFSA that does too much stock trading as carrying on a business.) The Budget introduced a rule, effective for 2019, that holds you jointly and severally liable for the tax owing on this business income. The liability of the issuer of the TFSA (the trustee) for this tax will be limited to the amount of property held in the TFSA, plus the amount of all distributions of property from the TFSA from the date the CRA sends the notice of assessment for this tax.

- <u>Tax benefits for Canadian journalism:</u> The Budget introduced new tax benefits for Canadian journalism organizations that meet certain criteria. If an organization qualifies, it will be considered a “qualified donee”, meaning that donations to the organization will qualify for the charitable-donation tax credit. A qualifying organization can also earn a refundable "labour tax credit" in respect of eligible newsroom employees. For 2020-2024, taxpayers will also qualify for a non-refundable 15% tax credit for subscriptions to Canadian digital news (limit of $500 per year in subscriptions, so the credit is limited to $75).

- <u>Transfer to individual pension plan (IPP):</u> An IPP is a type of defined benefit pension plan with fewer than four members. Under current rules, an individual who terminates membership in a defined-benefit pension plan can transfer about 50% of the commuted value on a tax-free basis to an RRSP. In contrast, the individual could transfer the full commuted value of the pension on a tax-free basis to a new IPP sponsored by a corporation that the individual controls. The Budget introduced a new rule that prevents this latter tax-free transfer – basically, it will not be allowed to an IPP to the extent the amount transferred is in respect of benefits accrued with a former employer. Such amount will be included in the individual's income.

- <u>Zero-emission vehicles:</u> The Budget introduced new depreciable property classes for zero-emission vehicles for capital cost allowance (CCA) purposes. Class 54 will include most regular automobiles, SUVs and vans (with a deprecation value limit of $55,000), while class 55 will include vehicles such as taxi cabs, and heavy trucks and tractors designed for hauling freight. A special enhanced 100% CCA rate will apply to vehicles purchased and available for use after March 18, 2019 and before 2024. Starting in 2024, the enhanced CCA rate will be phased out, with a 75% rate for 2024 and 2025, and 55% for 2026 and 2027. Beginning in 2028, the regular CCA rate will be 30% for class 54 and 40% for class 55.

  Among other things, in order to qualify for the enhanced CCA rate, the vehicle must be fully electric, or a plug-in hybrid with a battery capacity of at least 15 kWh or fully powered by hydrogen.

- <u>Scientific Research and Experimental Development (SR&ED) investment tax credit:</u> Under current rules, a 35% refundable tax credit is allowed for Canadian-controlled private corporations on up to $3 million of qualifying SR&ED expenditures in a taxation year. The credit is phased out if the corporation's taxable income exceeds $500,000 in the previous year or if its taxable capital for the previous year exceeds $10 million. The Budget eliminated the taxable *income* phase-out, effective for taxation years ending after March 18, 2019, so that on a go-forward basis only the taxable *capital* phase-out will apply.

- "Allocation to redeemers methodology": This is a method applied by mutual fund trusts under which they can allocate their capital gains to unitholders who are redeeming their units in the trust. The mutual fund is allowed to deduct the allocated amount, which is included in the redeeming unitholder's income, but which also reduces the unitholder's redemption proceeds (thus reducing its capital gain, if any, on the redemption of the units). This method is meant to prevent double taxation. However, it appears that some mutual funds have been allocating capital gains to redeeming unitholders in excess of the capital gains that would otherwise have been realized by these unitholders on the redemption of their units. In such case, the allocation could eliminate the unitholder's capital gain on the redemption of the units, while the excess portion could result in a capital loss that could offset the capital gain allocated by the mutual fund. The Budget introduced a new rule that effectively shuts down this strategy.

- Employee stock options: Under current rules, employee stock option benefits are generally only half taxed; that is, although they are fully included in income, the employee is normally allowed a deduction of half of the benefit in computing taxable income (so that the tax is equivalent to that on a capital gain). The Budget proposes to limit the preferential one-half taxation to stock options reflecting an annual cap of $200,000 worth of employee stock option grants (at the time of the grant of the option). Stock option benefits over that limit will be fully taxed, although the employer will normally be allowed a deduction. The limit is intended to apply to "individuals employed at large, long-established, mature firms". The government noted that the limit will *not* apply to employees of "start-ups and rapidly growing Canadian businesses" but the Budget papers did not define this term. In this regard, the government stated that more details will follow before the summer of 2019, and that the proposed changes will take effect only on a go-forward basis once the new details are now announced. Furthermore, the new limit will "not apply to employee stock options granted prior to the announcement of legislative proposals to implement any new regime." In other words, employee stock options granted currently or otherwise before the legislative proposals (which will likely not be released until fall 2019) will be grandfathered and not subject to the $200,000 limit. (Of course, whether this proposal proceeds will depend on whether the Liberals are re-elected in October 2019.)

Many of the Budget proposals are included in Bill C-97, which was introduced in Parliament in April and is expected to be enacted in June. Others, including the employee stock options changes, are not yet in legislative form and might not proceed if the Liberals are not re-elected in October.

THE CAPITAL GAINS EXEMPTION

Qualified small business corporation shares

The lifetime capital gains exemption allows individuals investing in shares in small business corporations to earn a significant amount of tax-exempt capital gains when they sell the shares. The lifetime limit is indexed annually for inflation. For 2019, the limit is $866,912. Since only one-half of capital gains are included in income as taxable capital gains. the exemption effectively exempts $433,456 of taxable capital gains.

In order to qualify for the exemption, the shares must be qualified small business corporation (QSBC) shares. Various conditions must be met for the shares to qualify. The main conditions are:

- At the time of the disposition of the share, the corporation must be a "small business corporation". In general terms, this means that the corporation is a Canadian-controlled private corporation (CCPC), and at least 90% of its assets on a fair market value basis consist of property used in an active business carried on primarily in Canada, shares or debt in other small business corporations, or a combination of such assets. A CCPC is a private corporation resident in Canada that is not controlled by non-residents or public corporations or a combination of the two. Thus, for example, if you are a Canadian resident and you control a private corporation resident in Canada, it will be a CCPC. "Control" typically means ownership of shares entitling you to more than 50% of the votes.

- Normally, the shares must have been owned by you or a related person throughout the 24 months before you dispose of the shares. There are some exceptions to this rule. For example, if you incorporate your existing business and transfer substantially all of the business assets into the corporation, the 24-month period does not apply to your shares in the corporation.

- Throughout the two-year period before you dispose of the shares, more than 50% of the corporation's assets must have been used in a business carried on primarily in Canada. Special rules apply where the corporation owned shares or debt in other corporations in this period.

CNIL and ABILs Affect Exemption

The amount of taxable capital gains that qualify for the exemption is reduced by the amount of your cumulative net investment losses (CNIL), going back as far as 1988. Basically, these are your investment losses in excess of your investment income over that entire 30+ year period.

Additionally, the exemption is reduced by the amount of your allowable business investment losses in the year and in previous years. In general terms, an ABIL is one-half of a capital loss realized on the disposition of shares or debt in small business corporations under specific circumstances. Unlike regular capital losses, ABILs are deductible from all sources of income, which is a good thing. The bad thing, as noted, is that they reduce your capital gains exemption.

> **Example**
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> In 2016, you claimed a $60,000 ABIL. In 2019, you have a $100,000 taxable capital gain from the disposition of QSBC shares. Only $40,000 of the taxable capital gains will qualify for the exemption.
>
> Since the $60,000 ABIL reduced your exemption on this disposition, it will not affect your exemption in the future. For example, if you have a further $30,000 taxable capital gain from a disposition of QSBC shares in 2020, the 2016 ABIL will not affect your exemption in 2020.

Qualified Farming or Fishing Property

A separate exemption applies to capital gains realized on the disposition of qualified farming or fishing property. The lifetime exemption covers $1 million of capital gains on such property.

The properties that are eligible for this exemption include assets carried on by an individual personally in the business of farming or fishing, as well as certain shares in farming or fishing corporations or interests in farming or fishing partnerships. Various conditions apply, including holding periods and business-activity tests.

DEBT INSTRUMENTS WITHOUT ANNUAL INTEREST PAYMENTS

Most debt instruments, such as corporate and government bonds and GICs, pay interest at least annually. As such, you normally just report your interest in income in the year in which you receive it or it is receivable by you.

However, some debt instruments do not carry an annual rate of interest, and some are issued at a discount to their face amount. Examples of these instruments include government treasury bills and zero-coupon bonds. Other debt instruments, like certain term deposits, are issued at face value but all of the interest is payable upon maturity rather than annually. For these instruments, a special interest accrual applies.

Basically, the special accrual rule means that you cannot defer reporting all the interest until it is paid to you – and in this case of a long-term zero coupon bond, this could be 10 or 20 years or more. Instead, you are required to report the interest on an accrual basis. More particularly, you must include in income, for a taxation year, the interest that accrues to an "anniversary day" in the year. The anniversary day is one year less a day from the day the instrument is issued, plus every subsequent annual anniversary day until the instrument matures.

Note that since the first anniversary day will occur in the calendar year following the year the instrument is issued, you can effectively defer reporting interest that accrues to December 31 of that first year.

Example

You purchase a 3-year term deposit on July 1, year 1. It matures on June 30, year 4. All of the interest is payable on June 30, year 4.

The first anniversary day will be June 30, year 2. As such, twelve months' worth of interest, from July 1, year 1 to June 30, year 2, will be included in year 2. This means that the interest that accrued throughout the second half of year 1 is not taxed in year 1 but rather year 2.

A similar rule applies to a corporation owning this type of debt instrument, except there is no anniversary day rule. A corporation must simply include in income all the interest accrued to its taxation year-end. Thus, if your corporation has a calendar-year taxation year and it purchases the term deposit in the above example, it will include in year 1 the interest accrued to December 31, year 1. In year 2 it will include the interest accrued to December 31, year 2, and so on.

APPRENTICESHIP JOB CREATION TAX CREDIT

In order to encourage the hiring of apprentices in certain trades, employers are eligible for the apprenticeship job creation credit if they hire an "eligible apprentice". The credit for a taxation year equals the lesser of $2,000 and 10% of the "eligible salary and wages" payable by the employer to the eligible apprentice for the year in respect of the eligible apprentice's employment in Canada in the year.

Any unused credit may be carried back 3 years and carried forward 20 years.

An "eligible apprentice" is an individual who is employed in Canada in a prescribed trade during the first 24 months of the individual's apprenticeship contract that is registered with the government under a program designed to certify or license individuals in the trade. The prescribed trades for these purposes are the "Red Seal" trades for a province under the Interprovincial Standards Red Seal Program (see red-seal.ca).

The "eligible salary and wages" payable are the salary and wages payable by the employer to the eligible apprentice for the first 24 months of the apprenticeship, but not including bonuses, remuneration based on profits or certain taxable benefits.

AROUND THE COURTS

Wholly dependent person credit disallowed

Normally, you can claim the wholly-dependent person credit for a minor child living with you if you are single (including divorced, separated, or widowed). You cannot claim the credit if you are paying child support for the child to your former spouse. However, if both you and your former spouse are paying each other support, you may be able to claim the credit.

In the recent *Bayrack* case, the taxpayer and his former spouse had two children. The taxpayer paid his former spouse child support in a year and attempted to claim the wholly dependent person credit in respect of one of the children.

The taxpayer argued that the support court order referred to his payment as a "set-off", in that it was effectively his obligation to pay support to his former spouse net of her obligation to pay him support. As such, the taxpayer argued, they were both paying each other support such that he could claim the credit.

The CRA denied the credit on the basis that only the taxpayer was paying child support. On appeal, the Tax Court of Canada agreed with the CRA and denied the credit. The Tax Court Judge interpreted the support court order as directing only the taxpayer to make support payments, and that there was no order for his spouse to make partially offsetting payments. According to the Judge, the net payments made by the taxpayer "represented a set-off of their respective financial abilities rather than a set-off of respective child support payments." Perhaps, then, if the support court order had specified that there was a set-off of their respective child support payments owing to each other, the taxpayer would have been allowed the credit.

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