# The Stikeman Elliott
# Federal Budget Commentary 2019

March 19, 2019

## Running Out of Options

### Highlights

**Proposed Change to Preferential Tax Treatment for Stock Options**

New annual cap of $200,000 on options granted by large, mature companies that will be eligible for the 50% tax deduction.

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**Extension of Foreign Affiliate Dumping Rules**

Foreign affiliate dumping rules extended to Canadian resident corporations controlled by non-resident individuals and trusts.

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**Taxation of Mutual Fund Trusts**

Proposed rules may deny a deduction to a mutual fund trust of a portion of capital gains and income attributed to redeeming unitholders.

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**Withholding Tax on Cross-Border Securities Lending Arrangements**

Proposed rules will ensure non-residents cannot avoid withholding tax on dividends from Canadian corporations by entering into securities lending arrangements in respect of shares of Canadian resident corporations.

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Stikeman Elliott's Tax Group has prepared a commentary on the 2019 federal budget.

### About Stikeman Elliott

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## Proposed Changes to Preferential Tax Treatment for Employee Stock Options: Not a Viable Option

Budget 2019 announced the Government's intention to limit the preferential tax treatment afforded to employee stock options. Currently, the *Income Tax Act* (Canada) (the "**ITA**") provides for a stock option deduction which, where available, effectively subjects the taxable benefit resulting from the exercise of stock options or sale of the shares underlying the stock options (as applicable) to tax at a rate equal to one-half of the ordinary personal tax rate, which mirrors the capital gains rate.[1]

The public policy rationale underlying this preferential tax treatment is to support younger and growing Canadian businesses which have limited ability to attract talent by paying competitive salaries. Instead, start-ups and other growing businesses can attract employees with stock options that offer employees a form of compensation linked to the future success of the business. However, this preferential tax treatment is also available to employees of large and mature businesses. Further, the Government is concerned with the disproportionate benefit of the preferential tax regime accruing to high-income individuals who often receive large percentages of their compensation through stock option benefits.

Budget 2019 proposes to introduce a $200,000 annual cap on employee stock option grants provided to employees of large and mature companies (based on the fair market value of the underlying shares at the time of grant) that will be eligible for the stock option deduction. Employee stock options granted by start-ups and rapidly growing businesses will be excluded from this annual cap.

For example, consider the taxation of an employee at a large, public company who is granted 100,000 stock options with an exercise price of $50, representing the fair market value of the shares on the date of grant, and such shares have increased in value to $70 at the time of exercise.

| | Current Tax Regime | Proposed Tax Regime |
|---|---|---|
| **Number of options granted** | 100,000 | 100,000 |
| **FMV of underlying shares on grant** | $50 | $50 |
| **Total FMV of underlying shares on grant** | $5,000,000 | $5,000,000 |
| **Options eligible for stock option deduction** | 100,000 | ($200,000 ÷ $50) = 4,000 |
| **Options not eligible for stock option deduction** | 0 | (100,000 – 4,000) = 96,000 |
| **Taxable benefit on exercise (pre-deduction)** | (100,000 x $70) - (100,000 x $50) = $2,000,000 | (100,000 x $70) - (100,000 x $50) = $2,000,000 |
| **Stock option deduction** | ($2,000,000 x 50%) = $1,000,000 | ((4,000 x $70) - (4,000 x $50)) x 50% = $40,000 |
| **Taxable benefit post-deduction** | $1,000,000 | $1,960,000 |
| **Tax payable on exercise*** | $535,300 | $1,049,188 |

**Assuming employee is in Ontario and is taxed at the highest marginal tax rate.*

[1] The taxable benefit resulting from the exercise of stock options granted to an employee must be included in an optionholder's income at the time the option is exercised, unless the employer is a "Canadian-controlled private corporation" (within the meaning of the ITA) and deals at arm's length with the optionholder, in which case the taxable benefit must be included in the optionholder's income at the time the shares received on the exercise of the options are sold.

The proposed measures are intended to better align with the tax treatment in the United States of employees of large and mature companies. Budget 2019 does not contain any draft legislation, but the Government has committed to provide further details before the summer of 2019. These proposed changes will not apply to employee stock options granted prior to the announcement of legislative proposals to implement the new regime.

# International Tax Measures

## Foreign Affiliate Dumping

The foreign affiliate dumping rules (the "**FAD Rules**") in the ITA were introduced as part of the 2012 federal budget with the stated objective of deterring certain transactions that were perceived to inappropriately erode the Canadian tax base. In order to meet this objective, the FAD Rules were amended on a number of occasions and have evolved into some of the most complex provisions under the ITA. Budget 2019 continues this trend.

The FAD Rules currently apply where a "corporation resident in Canada" (called a "**CRIC**") has made an "investment" in a foreign affiliate of the CRIC and the CRIC is controlled by a non-resident corporation. 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 persons that do not deal with each other at arm's length, comprising any combination of non-resident corporations, non-resident individuals and non-resident trusts.

This amendment will apply to transactions and events that occur on or after Budget Day. This proposed amendment will likely have an impact upon a number of structures in which *de jure* control of a Canadian corporation currently rests with a non-resident individual or trust.

## Cross-Border Securities Lending Arrangements

Derivative arrangements have been a source of concern for the Department of Finance for a number of years and previous budgets over the last several years have been slowly eliminating tax benefits that can be achieved through the use of these arrangements. These changes have included rules dealing with "derivative forward agreements" that had been used to convert ordinary income into capital gains and "synthetic equity arrangements" that allowed certain financial institutions to create tax shelter by entering into equity swaps that provided them with a deduction for payments made under the swap while the income earned to finance the payment was a tax-free intercorporate dividend. To date, structures used to minimize or avoid Canadian withholding tax on dividend equivalent payments made to non-residents have escaped the legislator's grip. Budget 2019 includes proposed changes to address this issue.

A non-resident that owns shares of a Canadian corporation can enter into a securities lending arrangement ("**SLA**") in respect of the shares and lend the shares to a Canadian financial institution. Under the arrangement, the financial institution is required to make dividend compensation payments to the non-resident in respect of dividends paid on the lent shares. Under current rules, if the SLA is not fully collateralized, the dividend compensation payment is treated as a payment of interest which is generally exempt from Canadian withholding tax. Alternatively, if the SLA does not meet the technical definition of a SLA under the ITA, the dividend compensation payments are simply contractual payments that are arguably not subject to Canadian withholding tax.

The proposed rules provide that any dividend compensation payment made under a SLA or a "specified securities lending arrangement" by a Canadian resident to a non-resident in respect of a share of a

Canadian resident corporation is always treated as a dividend that will be subject to Canadian withholding tax. A "specified securities lending arrangement" is a securities loan that is substantially similar to a SLA as defined under the ITA.

For purposes of determining the withholding tax rate on the compensation payment under an applicable treaty, the lender will be deemed to have received the dividend payment from the issuer of the underlying share.

The proposed rules will also ensure that dividend compensation payments received in respect of shares issued by non-resident corporations pursuant to fully collateralized SLAs will not be subject to Canadian withholding tax.

It is somewhat interesting that the proposals apply only to dividend compensation payments made pursuant to SLAs and not more broadly to dividend equivalent payments made under other types of derivative transactions that allow non-residents of Canada to obtain economic exposure to shares issued by Canadian resident corporations.

The proposed rules will apply to any dividend compensation payments made on or after Budget Day unless the arrangement was in place on Budget Day, in which case the rules will apply to payments made after September 2019.

### Transfer Pricing

Budget 2019 proposes two new measures concerning the interaction of the transfer pricing rules and the other provisions of the ITA. First, Budget 2019 proposes to amend the ITA to clarify that the transfer pricing rules apply in priority to the application of the provisions in other parts of the ITA, including the provisions relating to the computation of income under Part I of the ITA. This measure will apply to taxation years that begin on or after Budget Day. Second, Budget 2019 proposes to apply the expanded definition of "transaction" used in the transfer pricing rules for the purposes of the extended reassessment period that generally applies in the transfer pricing context. Generally, after a taxpayer files an income tax return, the Canada Revenue Agency ("**CRA**") is required to perform an initial examination of the return and assess tax payable with all due dispatch. The CRA then has a fixed period (typically 3 or 4 years) after issuing a tax assessment after which it is precluded from reassessing the taxpayer. However, an extended three-year reassessment period applies in respect of a reassessment made as a result of a transaction involving a taxpayer and a non-resident with whom the taxpayer does not deal at arm's length. Currently, the expanded definition of "transaction" (which is defined to include an arrangement or event) included in the transfer pricing rules does not apply for purposes of the rule establishing this extended reassessment period. This measure will apply to taxation years for which the normal reassessment period ends on or after Budget Day.

## Personal Income Tax Measures

### Mutual Fund Trusts

Budget 2019 contains changes to the rules that determine the taxation of mutual fund trusts ("**MFT**") and their holders on the redemption of units. Generally, MFTs are structured to operate as flow-through entities, such that income and gains realized in a MFT are taxed in the hands of the unitholders, and not within the trust itself. This is achieved by permitting MFTs to distribute their income and gains to their unitholders on an annual basis, and receive a corresponding deduction for any distributed income and gains. Most MFTs are structured to automatically distribute all of their net income and gains in the year to ensure that no tax is paid at the MFT level.

In addition to paying tax on distributions of income and gains from a MFT, a unitholder may also realize a capital gain on the disposition of a mutual fund trust unit (or may realize income, in the more unusual situation where the holder holds its units on income account). Accordingly, in a situation where a unitholder redeems its units, there is the potential for tax to be realized at both the MFT level (which tax may be shifted to unitholders) and the unitholder level. This is the case because often a mutual fund trust will need to sell a portion of its underlying investments in order to generate the cash required to redeem the unitholder's units. This will trigger any accrued gains on the underlying investment. In addition, the unitholder realizes any accrued gains on his or her units on the disposition.

There are currently two ways that mutual fund trusts deal with this situation in order to avoid, or at least reduce, this double tax:

- First, the ITA contains a "capital gains refund" mechanism which provides the MFT with a deduction for a portion of capital gains realized in the year. The refund is determined through a formula which takes into account the value of redemptions throughout the year and the undistributed capital gains realized by the MFT during the year. Given the formulaic nature of this calculation, it does not always result in an accurate reflection of the capital gains attributable to redeeming unitholders during the year.

- Second, MFTs disproportionately allocate capital gains to redeeming unitholders. This is generally tax-neutral from the unitholder's perspective because the unitholder is permitted to reduce its "proceeds of disposition" on the redemption of its units by any income or capital gains distributed to them on the redemption. Accordingly, any capital gain that the unitholder would otherwise realize on the disposition of its units is reduced, and a capital loss may be created. The reduced capital gain, and if applicable the capital loss, offset any capital gain distributed by the MFT.

Given the inaccuracy of the "capital gains refund" mechanism, in practice many MFTs rely on the second method, and disproportionately allocate capital gains to redeeming unitholders instead of relying on the "capital gains refund". Budget 2019 confirms that this method is acceptable provided that the capital gains allocated to redeeming unitholders are not in excess of the capital gains that would otherwise have been realized by those redeeming unitholders on the disposition of their units. Budget 2019 identifies, and proposes to stop, two forms of perceived abuses involving allocations to redeeming unitholders: (i) a deferral of capital gains, and (ii) the conversion of income into capital gains.

**Capital Gains Deferral**

Budget 2019 proposes to prevent a MFT from deducting a capital gain that is allocated to a departing unitholder where that capital gain is in excess of the capital gain that would otherwise be realized by that holder. This will be implemented through a rule which will require the MFT to calculate, on a unitholder by unitholder basis, the capital gain realized by each redeeming unitholder. The MFT will be denied a deduction to the extent that the gain allocated to the particular unitholder exceeds the unitholder's capital gain. This will increase the capital gains that must be distributed to other unitholders, and therefore will prevent these gains from being deferred until those unitholders sell their units.

Going forward, this may force certain MFTs to rely much more heavily on the "capital gains refund" mechanism, which as discussed above is not ideal as it does not always provide an accurate mechanism for matching MFT level capital gains with gains that relate to redeeming unitholders. Furthermore, where a MFT's units are traded, accrued gains at the trust level may not correspond to accrued gains at the unitholder level since some unitholders will have a higher cost base in their units as a result of acquiring units from another holder at a price which already reflects the accrued gains inside the MFT. Furthermore, it is unclear whether widely-held, publicly traded MFTs will have the information available to them to calculate each unitholder's capital gain on a redemption of units.

These changes are effective for taxation years beginning on or after Budget Day. Accordingly, for any MFT with a calendar year fiscal year the changes will be effective as of the 2020 taxation year.

**Income Conversion**

As discussed above, a unitholder who is allocated capital gains on the disposition of units is generally indifferent. By contrast, if a redeeming unitholder is allocated income, this could have the effect of converting a capital gain into ordinary income. Assuming the unitholder holds its units as capital property (which is the case for most investors), this is a bad result for investors and therefore MFTs would not typically disproportionately allocate income to redeeming unitholders. However, in the case of a unitholder who holds its units on income account (which may include certain financial institutions, for example), they would generally be indifferent as to the amount of income allocated to them on the redemption, for the same reasons discussed above.

Budget 2019 also proposes to prevent MFTs from deducting income that is allocated to redeeming unitholders. This will prevent, for example, a plan where a unitholder who holds on income account acquires MFT units for a short period of time with the deliberate intention of allowing the MFT to disproportionately allocate income to such holder. However, it may also prevent income allocation to redeeming unitholders in situations where the distribution would otherwise be appropriate.

These changes are also effective to taxation years beginning on or after Budget Day.

### Change in Use Rules for Multi-Unit Residential Properties

The ITA contains rules that deem a taxpayer to have disposed of property, and to have immediately reacquired such property, at fair market value where capital property is converted to or from income-earning property. The deemed disposition could occur, for example, where a taxpayer starts to use rental property for personal residential use, or vice-versa. The deemed disposition can also apply where only part of the capital property changes in use in the case of a multi-unit residential property, such as a duplex.

Elections may be available on a change in use of an entire property to avoid the deemed disposition from arising, and to thereby defer the realization of any accrued capital gain on the property to the time it is actually sold. An election may also be available to designate said property as a taxpayer's principal residence for an additional period of up to four years before or after the period for which the taxpayer could otherwise claim the principal residence exemption in respect of the property. Under the current rules, the foregoing elections are not available for partial changes in use relating to multi-unit residential properties.

Budget 2019 proposes to extend the available elections above to partial changes in use with respect to a multi-unit residential property, to improve the consistency in treatment of owners of single-unit and multi-unit residential properties. The announced measures will apply to changes in use of property that occur on or after Budget Day.

## Business Income Tax Measures

### Further Reducing the Cost of Innovation of CCPCs through Refundable SR&ED Credits

The Scientific Research and Experimental Development ("**SR&ED**") tax incentive program helps reduce the cost of innovation in Canada. It is worth noting that to qualify for the incentives, the R&D activities must entail the advancement of scientific knowledge or technology. The SR&ED program provides that qualifying R&D expenses are immediately deductible in the year they are incurred, and grants investment tax credits ("**ITCs**") which may further reduce taxes payable. An enhanced federal ITC rate of 35% is available for Canadian-controlled private corporations ("**CCPCs**"), and ITCs up to the $3 million annual expenditure limit are generally fully refundable. Under the current rules, the expenditure limit is progressively phased out based on two factors, which apply on the basis of an associated group. The factors under the current rules are as follows:

1. where taxable income from the previous taxation year is between $500,000 and $800,000; and

2. where taxable capital employed in Canada for the previous taxation year is between $10 million and $50 million. The taxable capital of a corporation is, in general, the aggregate of its equity and debt, less any investments and loans made to other corporations**.**

Budget 2019 proposes to repeal the use of taxable income as a factor in determining a CCPC's annual expenditure limit. In other words, the $3 million annual expenditure limit applicable to CCPCs seeking to claim enhanced ITCs at the 35% rate is no longer gradually reduced and eliminated where taxable income from its previous taxation year exceeds $500,000. This proposal not only enhances the incentives available to CCPCs, but also makes the phase-out of incentives more predictable for Canadian businesses.

The announced measures will apply to taxation years that end on or after Budget Day. The table below summarizes the applicable credit and refund rates on eligible R&D expenses for such taxation years depending on the type of corporation.

| **Type of corporation** | **Credit Rate** | | **Refund Rate** | |
|---|---|---|---|---|
| | R&D Expenses up to $3 million | R&D Expenses Exceeding $3,000,000 | R&D Expenses up to $3,000,000 | R&D Expenses Exceeding $3,000,000 |
| **CCPC taxable capital $10 million** | 35% | 15% | 100% | 40% |
| **CCPC having taxable capital over $50 million**[2] | 15% | 15% | 0% | 0% |
| **Non CCPC** | 15% | 15% | 0% | 0% |

## Character Conversion Transactions

As noted above, a previous budget introduced rules applicable to derivative forward agreements that were designed to prevent the use of derivatives by taxpayers to convert ordinary income into capital gains. Forward sale or purchase transactions were commonly used by Canadian MFTs to give unitholders economic exposure to a portfolio of investments that generated ordinary income in a manner that converted the return on the investments into a capital gain. Generally, under a forward purchase transaction, the mutual fund trust would prepay an amount to a counterparty in exchange for the right to be delivered a basket of "Canadian securities" that had a value equal to the value of a reference basket of investments. On termination of the forward purchase agreement, the MFT would acquire the Canadian securities and then immediately sell them and distribute the proceeds to its unitholders. The mutual fund trust would file an election under subsection 39(4) of the ITA to ensure that the gain on the sale of the

[2] The $3 million expenditure limit is still gradually reduced and eliminated where taxable capital is between $10 million and $50 million.

securities would be treated as a capital gain. The rules relating to derivative forward agreements ensured that this gain would be treated as ordinary income.

There is an exception to the derivative forward agreement definition for purchase agreements under which the value of the securities to be delivered is based on the value or economic performance of the actual securities to be delivered under the agreement. This exception was designed to ensure that ordinary commercial transactions such as option agreements or agreements of purchase and sale were not caught by the rules. However, this exception could also be used in a manner that may be seen as circumventing the policy behind the rules. For example, a MFT could enter into a pre-paid forward agreement to acquire units of another trust that held income producing investments. On termination of the agreement, the MFT would acquire the units of the other trust and then immediately sell or redeem those units realizing a capital gain. The derivative forward agreement rules would not apply because the value of securities to be delivered under the agreement was based on the economic performance of those same securities.

Budget 2019 will amend the rules relating to derivative forward agreements to add a qualification to the exception described above as it relates to an agreement to purchase a security. Under this qualification, the exception will not apply if it can reasonably be considered that one of the main purposes of the series of transactions that includes the agreement to purchase the security is to convert into a capital gain an amount paid on the security while the security is subject to the agreement.

This proposal will apply to transactions entered into on or after Budget Day. It will also apply after December 2019 to transactions that were entered into before Budget Day and will contain rules to prevent upsizing of grandfathered transactions on or after Budget Day.

## Other Tax Changes

Given this is an election year budget there had to be some tax incentives provided. The Budget proposes a temporary 100% depreciation rate for zero-emission vehicles used for business purposes, further tax assistance for first-time home buyers and tax credits for amounts paid by individuals for digital news subscriptions provided by qualified Canadian journalism organizations.

## Pension-Related Proposals

Budget 2019 includes several announcements aimed at private pension plan sponsors, including proposals to:

- amend the *Companies' Creditors Arrangement Act*, the *Bankruptcy and Insolvency Act*, to "better protect workplace pensions in the event of corporate insolvency" through making "insolvency proceedings fairer, more transparent, and more accessible for pensioners and workers".

- amend the *Canada Business Corporations Act* to make "clear that federally incorporated businesses are able to consider diverse interests, such as those of workers and pensioners, in corporate-decision making" and to require publicly traded, federally incorporated firms to "disclose their policies pertaining to workers and pensioners and executive compensation, or explain why such policies are not in place" and to hold and disclose the results of non-binding shareholder votes on executive compensation.

- amend the *Pension Benefits Standards Act, 1985* to clarify that if a federally regulated pension plan is wound-up, it must still provide the same pension benefits as when it was ongoing, and to allow defined benefit plans to fully transfer the responsibility to provide pensions to a regulated life insurance company through the purchase of annuities - similar to the so-called "annuity discharge" contained in Bill C 27.

Many will recognize several of the above proposals as those on which the Government consulted late last year. Most pension stakeholders will welcome the “annuity discharge”. The other proposals are either too imprecise to offer any commentary at this point or will not be viewed by many as a positive development. Specifically, amending the *Pension Benefits Standards Act, 1985* to clarify that benefits must be the same on wind-up as they are in an ongoing pension plan has the potential to undermine responsibly designed plans that have conditional indexation or other benefits that are only paid when the plan can afford it.

Other pension-related proposals include amendments to the *Bank of Canada Act* and *Pension Benefits Standards Act, 1985*, to allow unclaimed pension balances from terminated federally regulated pension plans to be transferred to the Bank of Canada, changes to the specified multi-employer pension plans rules, and changes aimed at curbing the use of individual pension plans as a tax planning tool.