TAX NOTES

April 8, 2022

BUDGET 2022

Minister of Finance Chrystia Freeland tabled Budget 2022 on April 7, 2022. Budget 2022 contains – or, in some cases, does not contain – several proposals that may be of interest to our clients, although draft legislation for most of these measures was not released as part of the accompanying Notice of Ways and Means Motion. In this Tax Note, we review the most significant items with potentially broad application and consider their potential impact.

Plus ça change…

Prior to Budget day, there was concern that the Department of Finance would, among other things, propose to increase the capital gains inclusion rate, cap or otherwise limit the principal residence exemption, or would take steps to curtail capital gains stripping transactions. Saving for a very narrow measure relating to house flipping (see below), none of these fears came to pass.

It was also expected that the Department of Finance would propose new rules governing inter-generational business transfers in late 2021 or early 2022, to replace the amendments made by Bill C-208. No legislative proposals to this effect were included in Budget 2022, although the Department of Finance announced a consultation process running through June 17, 2022. Potentially affected persons, especially in the agriculture industry, are encouraged to provide feedback to the Department of Finance.

Housing Measures

Budget 2022 contained a variety of tax and non-tax proposals relating to housing availability and affordability. On the tax side, the most important proposals relate to a new tax-free first home savings account and a residential property flipping rule. Draft legislation was not provided for either of these measures. Budget 2022 also proposes to increase the existing home buyers' tax credit and home accessibility tax credit, and to create a new multigenerational home renovation tax credit.

The proposed first home savings account, which will only be available to individuals who have not lived in a home they owned in the year the account is opened or the preceding four calendar years, will allow for lifetime contributions of up to $40,000 with an annual contribution limit of $8,000. The contributions will be deductible, like an RRSP, while a withdrawal to make a qualifying first home purchase will be tax-free, like a TFSA. Income earned in the account will be tax-exempt. It will be possible to transfer funds from an RRSP to a first home savings account, or from a first home savings account to an RRSP.

The proposed anti-flipping rule would deem any profit earned by an individual from the sale of residential real estate to be income from a business if the individual owned the property for less than 12 months. There are various exceptions to this deeming rule for life events like death, birth, divorce, or bankruptcy. Given the various exceptions, this deeming rule is unlikely to produce results that would not have been produced under existing case law or to provide much additional certainty, but may dissuade some house flippers at the margins.

A GST/HST proposal would cause the supply of the rights under a contract for the purchase of a new or substantially renovated single unit residential complex or residential condominium unit to be a taxable supply, regardless of the reason for the supply. The consideration for this supply will not include the amount of any deposit assigned to the assignee as part of the supply of the contract. This proposal would apply to assignment sales entered into on or after May 7, 2022.

Registered Charities

In a move that had been previously signalled, the Department of Finance has proposed that the annual disbursement quota for charities will be increased from 3.5% to 5% of assets not used directly in charitable activities, but only where the fair market value of these investment assets exceeds $1,000,000. An amendment will also clarify that expenditures for administration and management of the charity are not qualifying expenditures for the purpose of satisfying the disbursement quota. Disappointingly, draft legislation was not provided.

More surprisingly, Budget 2022 contains a proposal that will permit registered charities to make qualifying disbursements to organizations that are not qualified donees (e.g., not-for-profit organizations) to further their charitable objects, if record-keeping and accountability requirements are met. An anti-avoidance rule will apply to prevent charities from being used as a conduit through which donors can receive a tax credit for what would effectively be a donation to a non-qualified donee. Again, draft legislation was not provided.

Flow-Through Shares

Budget 2022 proposes to eliminate flow-through shares for oil, gas, and coal activities, effective March 31, 2023. However, a new critical mineral exploration tax credit will allow for flow-through treatment and a 30% credit for exploration activities relating to various minerals used to make batteries and semiconductors. The critical mineral exploration tax credit would apply to flow-through share agreements entered into between April 8, 2022 and March 31, 2027.

Small Business Deduction – Taxable Capital Limit

Under current law, the business limit for a Canadian-controlled private corporation (CCPC) is reduced when the CCPC, together with its associated group, has taxable capital in excess of $10,000,000. The business deduction limit will be reduced to nil when the CCPC, together with its associated group, has taxable capital of $15,000,000 or more. This phase-out has been criticized for unfairly penalizing capital intensive businesses, especially if after-tax profits would be reinvested in the business.

Budget 2022 proposes to reduce the rate at which the business limit is reduced when taxable capital exceeds $10,000,000, such that the business limit will not be reduced to nil until taxable capital of the CCPC and its associated group equals or exceeds $50,000,000. No draft legislation was provided for this measure, which is to be effective in taxation years beginning on or after April 7, 2022.

General Anti-Avoidance Rule (GAAR)

Recent decisions of the Tax Court of Canada and the Federal Court of Appeal have confirmed that the GAAR cannot apply to transactions that create tax attributes, like non-capital losses, paid-up capital, or capital dividend account, until those attributes are used to reduce or defer tax. This may have been administratively inconvenient for the CRA, as it was required to track tax attributes it believed to have been created via abusive tax avoidance until those attributes were in fact used.

Budget 2022 proposes to allow the CRA to issue notices of determination in relation to amounts that could be relevant in the future to computing tax payable or determining a taxpayer's income entitlement. If this measure is enacted by Parliament, which is almost certain, these determinations can be issued by the CRA on or after April 7, 2022 in respect of any tax attributes, regardless of the taxation year in which the attributes were created. A determination of a tax attribute using the GAAR is treated as an assessment, so affected taxpayers should be able to file a notice of objection and to appeal to the Tax Court of Canada as they otherwise could have had the CRA waited to issue a reassessment until the tax attributes were used.

<u>Non-CCPCs and Controlled Foreign Affiliates</u>

Non-CCPC plans have been very popular for the last decade. These plans require a corporation to avoid or lose CCPC status, for example by issuing options to acquire shares to non-residents or by continuing the corporation to a non-treaty jurisdiction. If successful, the non-CCPC will be subject to tax on its investment income at the general corporate rate, allowing for a significant deferral.

Budget 2022 proposes to curb non-CCPC planning through the creation of a "substantive CCPC" concept. A substantive CCPC will be a private corporation, other than a CCPC, that is controlled *de jure* or *de facto* by Canadian resident individuals at any time in a taxation year. A corporation that is not a substantive CCPC will be deemed to be a substantive CCPC if one of the purposes of any transaction or series of transactions is to cause the corporation to not be a substantive CCPC. If a corporation is a substantive CCPC, it will be subject to refundable taxes on investment income and would be entitled to a dividend refund when non-eligible dividends are paid. The substantive CCPC's low-rate income pool will be increased by any investment income earned.

No draft legislation has been released for this measure, which may apply retroactively to taxation years that *end* on or after April 7, 2022. Corporations that would be substantive CCPCs that have not yet had their first year-end should consider selecting a taxation year that ends before April 7, 2022.

To backstop the substantive CCPC rules, Budget 2022 also proposes to amend the rules applicable to the foreign accrual property income (FAPI) earned by controlled foreign affiliates. At a high level, the proposed amendments would:

- Require a controlled foreign affiliate to be subject to foreign tax on its FAPI at an effective rate of 52.63% before the shareholder of a controlled foreign affiliate that is a CCPC or substantive CCPC would be entitled to a deduction for foreign accrual taxes sufficient to offset any FAPI inclusion.
- Require a foreign affiliate to be subject to foreign tax on the taxable portion of capital gains included in hybrid surplus at an effective rate of 52.63% (including withholding taxes) before the shareholder of a foreign affiliate that is a CCPC or substantive CCPC would be entitled to a deduction for the full amount of a dividend paid from hybrid surplus.
- Require a foreign affiliate to be subject to foreign tax on taxable earnings at an effective rate of 52.63% (including withholding taxes) before the shareholder of a foreign affiliate that is a CCPC or substantive CCPC would be entitled to a deduction for the full amount of a dividend paid from taxable surplus.
- Not allow CCPCs to add an amount to their general rate income pool on account of the deductible portion dividends paid by a foreign affiliate or a controlled foreign affiliate from its hybrid surplus or taxable surplus.

- Increase the capital dividend account of a CCPC or substantive CCPC by the amount of dividends received from a foreign affiliate or controlled foreign affiliate that are paid from hybrid surplus or taxable surplus and were subject to foreign tax at an effective rate of 52.63%.

No draft legislation was provided in respect of this proposal.

OECD Pillar One & Pillar Two

Unsurprisingly, the Department of Finance intends to propose legislation to implement the OECD's Pillar One and Pillar Two plans. In the interim, legislation to implement the proposed digital services tax will continue to progress even though the Department of Finance assumes that it will never come into effect. A consultation project concerning various aspects of the Pillar Two proposals was announced in Budget 2022; this consultation project will continue through July 7, 2022. The Department of Finance expects that legislation implementing the Pillar One and Pillar Two rules will come into effect in 2023.

Previously Announced Measures

The Department of Finance announced in Budget 2022 that it intends to proceed with various previously announced measures that have not yet been enacted by Parliament. These measures include the proposed luxury tax, mandatory disclosure rules, hybrid mismatch arrangement rules, transfer pricing consultation, and the output of the GAAR consultation. No indication was given as to when draft legislation or updated draft legislation would be released, or when these items would be included in a Bill presented to the House of Commons.

Conclusion

From a tax standpoint, Budget 2022 is ambitious but lacking detail; there are many other legislative proposals relating to (among other things) carbon capture technologies, withholding taxes, financial institutions, and GST/HST that we have not reviewed in this Tax Note, and draft legislation for most of these measures did not accompany the Budget Plan. This is probably a by-product of the Department of Finance's considerable to-do list. The real impact of Budget 2022 will likely not be known for many months, until after all announced consultations have been completed and technical amendment bills are introduced in the House of Commons.

We will be circulating a separate Tax Note addressing the proposals relating to an investment tax credit for carbon capture/storage and capital cost allowance for clean energy equipment.

If you have any questions about any proposed measures in Budget 2022 and their impact on you or your clients, please contact one of our lawyers.