2022 Federal Budget Review

Finance Minister Chrystia Freeland presented her second Budget (and first from the re-elected minority Federal Liberal government) in the House of Commons on April 7, 2022.

As expected, Budget 2022, entitled "A Plan to Grow Our Economy and Make Life More Affordable," contains significant spending initiatives focussed on housing affordability, child care, dental care, transition to a green economy, productivity and innovation. The Budget announced over $31 Billion of new spending, anticipates a deficit of $113.8 Billion for fiscal 2021-22, a deficit of $52.8 Billion for 2022-23, and more modest deficit amounts thereafter.

The most significant new revenue sources proposed in the Budget include two new measures affecting banks and life insurers, namely a temporary "Canada Recovery Dividend" — a one-time, 15 per cent tax on taxable income above $1 Billion for the 2021 tax year, to be paid in equal installments over five years — as well as a permanent increase in the corporate income tax rate by 1.5 per cent on taxable income exceeding $100 Million.

From a personal and small business tax perspective, which is the focus of this review, the Budget did not introduce any broad-based tax increases, nor any changes to capital gains inclusion rates. However, access to the principal residence exemption may now be restricted for house "flips." As expected, the Budget expanded on many of the key themes announced in the Liberal government's Election platform and 2021 Fall Economic Statement, with a significant focus on housing measures, including the introduction of a new savings account for first-time homebuyers and several new or enhanced housing tax credits. For Canadian-controlled private companies (CCPCs), significant measures include a reduction in the claw back of the small business deduction for growing businesses and proposals to curtail planning to avoid paying refundable corporate income tax on investment income. Charities and donors should also note that the Budget proposes to increase the disbursement quota beginning in 2023.

As in prior years, the Budget proposes additional measures that seek to improve the fairness and transparency of the tax system, increased funding for the Canada Revenue Agency to combat aggressive tax planning, and new initiatives to ensure that the Federal government is delivering effective programs and services.

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

Housing Measures

A significant theme in Budget 2022 is housing, with a comprehensive plan to make housing more affordable including a one-time, $500 payment to those facing housing affordability challenges, a focus on doubling the rate of new builds over the next decade while introducing measures to help Canadians buy their first home, protect buyers and renters, and curb foreign investment and speculation.

Specific tax measures related to housing include the following:

- Doubling support provided through the First Time Home Buyers' Tax Credit, from $750 to $1,500 (for homes purchased on, or after January 1, 2022);
- A new (refundable) Multigenerational Home Renovation Tax Credit, which would allow families to claim up to $7,500 (i.e., 15 per cent of up to $50,000 in eligible renovation and construction costs) for constructing a secondary suite for a senior or an adult with a disability, beginning with the 2023 taxation year;
- A doubling of the qualifying expense limit of the Home Accessibility Tax Credit to $20,000 (from $10,000) for the 2022 and subsequent tax years, to provide savings of up to $3,000 based on a 15 per cent Federal tax credit for accessibility renovations or alterations; and
- Proposals to ensure that "Assignment Sales" (i.e., speculative trading involving the resale of housing before it has been constructed or lived in) of newly constructed or substantially renovated residential housing will be taxable for GST/HST purposes, effective May 7, 2022.

Continued

Residential Property Flipping Rule

Budget 2022 also proposes to introduce new rules to ensure profits from flipping properties are taxed and the principal residence exemption is restricted to Canadians who use their houses as homes. Specifically, any person who sells a property they have held for less than 12 months would be considered to be flipping properties and would be subject to full taxation on their profits as business income. Exemptions would apply for Canadians who sell their home due to certain life circumstances, such as a death, disability, the birth of a child, a new job, or a divorce. Exemptions will be set in forthcoming rules and Canadians will be consulted on the draft legislative proposals. This new measure would apply to residential properties sold on, or after January 1, 2023.

Tax-Free First Home Savings Account

Budget 2022 proposes to introduce the **Tax-Free First Home Savings Account** (FHSA), a new registered account that would provide first-time home buyers the ability to save up to $40,000 towards the purchase of a first home. Combining hallmark attributes of RRSPs and TFSAs, contributions made into the FHSA would be tax-deductible and income earned in an FHSA would not be subject to tax. Qualifying withdrawals from the FHSA to purchase a first home (including investment income) would be non-taxable. The following are some key features of the FHSA:

Eligibility – To open an FHSA, an individual must be resident of Canada, at least 18 years of age, and must not have lived in a home that they owned either at any time in the year the account is opened, or during the preceding four calendar years.

Contributions – The lifetime limit (per individual) on contributions would be $40,000, subject to an annual contribution limit of $8,000. Unused annual contribution room cannot be carried forward, meaning that an individual contributing less than $8,000 in a given year would still face an annual limit of $8,000 in subsequent years. Although individuals may be permitted to hold more than one FHSA, the total combined amount of contributions to all of their FHSAs could not exceed their annual and lifetime limits.

Withdrawals – Amounts withdrawn to make a qualifying first home purchase would not be subject to tax. Amounts that are withdrawn for other purposes would be taxable. Individuals would be limited to making non-taxable withdrawals in respect of a single property in their lifetime, and once the withdrawal to purchase a home is made the individual would be required to close their FHSA(s) within a year from the first withdrawal and would not be eligible to open another FHSA.

Transfers – Funds could be transferred from an FHSA to an RRSP (at any time before the year that they turn 71) or to a RRIF. Transfers to an RRSP or RRIF would not be taxable at the time of transfer, but amounts would be taxed when withdrawn from the RRSP or RRIF in the usual manner. Such transfers would not reduce, or be limited by, the individual's available RRSP contribution room. Withdrawals and transfers would not restore FHSA contribution limits.

If an individual has not used the funds in their FHSA for a qualifying first home purchase within 15 years of first opening an FHSA, their FHSA would have to be closed and any unused savings could be transferred into an RRSP or RRIF (as noted above), or would otherwise have to be withdrawn on a taxable basis.

Individuals would also be allowed to transfer funds from an RRSP to an FHSA on a tax-free basis, subject to the $40,000 lifetime and $8,000 annual contribution limits. These transfers would not restore an individual's RRSP contribution room.

Interaction with Home Buyers' Plan (HBP) – The HBP allows individuals to withdraw up to $35,000 from an RRSP to purchase or build a home without having to pay tax on the withdrawal, with a repayment requirement over a period not exceeding 15 years (starting the second year following the year of withdrawal). The HBP will continue to be available under existing rules, but individuals will not be permitted to make both a FHSA withdrawal and an HBP withdrawal in respect of the same home purchase.

The government intends to work with financial institutions to ensure that FHSAs could be opened in 2023.

Other housing related measures

- An extended and more flexible First-Time Home Buyer Incentive (originally introduced in 2019) which allows eligible first-time home buyers to lower their borrowing costs by sharing the cost of buying a home with the government;
- A proposed "Home Buyers' Bill of Rights," including a national plan to end blind bidding, provide a legal right to a home inspection and ensuring transparency on the history of sales prices on title searches;
- A proposed Federal review of housing as an asset class in order to better understand the role of large corporate players in the market and the impact on Canadian renters and homeowners, including potential changes to the tax treatment of large, corporate players that invest in residential real estate; and
- New measures to curb foreign investment and speculation by proposing restrictions that would prohibit foreign commercial enterprises and people who are not Canadian citizens or permanent residents from acquiring non-recreational, residential property in Canada for a period of two years (with certain exceptions for refugees, international students on the path to permanent residency and individuals on work permits who are residing in Canada).

Other personal tax measures

Alternative Minimum Tax

As initially highlighted in its 2021 Election Platform, the Liberal government is seeking to ensure that high income earners pay income tax at a rate of at least 15 per cent each year and cannot artificially reduce their taxable income through excessive use of deductions or credits. Although the current Alternative Minimum Tax (AMT) regime has been in place since 1986, the government is concerned that as it has not been substantially updated since its introduction, there are still many wealthy Canadians who pay little to no personal income tax each year. Accordingly, Budget 2022 announced the government's commitment to examine a new minimum tax regime and plans to release details on a proposed approach in the 2022 Fall Economic and Fiscal Update.

Medical Expense Tax Credits

Budget 2022 proposes to allow medical expenses related to a surrogate mother, or a sperm, ova, or embryo donor that are incurred in Canada for 2022 and subsequent taxation years, to be claimed. This would include costs that have been reimbursed to a surrogate for in vitro fertilization expenses.

Budget 2022 also proposes to allow fees paid to fertility clinics and donor banks in Canada in order to obtain donor sperm and ova to be eligible under the Medical Expense Tax Credit for 2022 and subsequent taxation years.

Labour Mobility Deduction

The Budget also proposed a new Labour Mobility Deduction for tradespeople, which would provide tax deductibility on up to $4,000 per year in eligible travel and temporary relocation expenses to eligible tradespersons and apprentices, applicable to the 2022 and subsequent taxation years.

Proposals Affecting Canadian Private Companies

Non-CCPC Planning

Overview

The government has identified tax planning strategies that seek to alter the (CCPC) status of Canadian resident corporations in an attempt to avoid paying the additional refundable corporate income tax that they would otherwise pay on investment income earned in the corporations. The planning is often undertaken by moving a corporation into a foreign low-tax jurisdiction, by using foreign shell companies, or by moving passive portfolios to an offshore corporation.

Budget 2022 proposes targeted amendments to the *Income Tax Act* to ensure that, for taxation years that end on, or after April 7, 2022, investment income earned and distributed by private corporations that are, in substance, CCPCs is subject to the same taxation as investment income earned and distributed by CCPCs.

Background

Under Canada's integration regime, the income tax system aims to achieve neutrality by ensuring that income earned directly by a Canadian resident individual is taxed at roughly the same rate as income that is earned through a corporation. CCPCs earning *active* business income are subject to lower corporate tax rates and can, therefore, achieve a deferral of personal tax such that the income is integrated only once dividends are paid out to individual shareholders. In contrast, additional refundable taxes apply to *passive* investment income earned by CCPCs in the year in which such income is earned. These refundable taxes (forming part of the integration system) aim to remove any advantage for Canadian individuals of earning investment income in a CCPC (where the investment income would otherwise be subject to a lower tax rate), such that the total corporate tax rate (including refundable taxes) approximates the personal top marginal tax rate.

The government is concerned that some Canadians are manipulating the status of their corporations to avoid qualifying as a CCPC (under current tax laws), and avoid paying the additional refundable corporate income taxes to achieve a tax-deferral advantage on investment income earned in their corporations. This may be done in a number of ways, either by avoiding "Canadian corporation" status, by continuing a corporation into a foreign low-tax jurisdiction under foreign corporate law (while maintaining Canadian residency), or by avoiding "Canadian-controlled" status by interposing a non-resident corporation in the corporate structure or issuing share options to non-residents. In effect, avoiding either status would mean the corporation no longer qualifies as a CCPC.

Budget Proposals

Budget 2022 proposes targeted amendments to ensure that investment income earned and distributed by private corporations that are, in substance, CCPCs is subject to the same taxation as investment income earned and distributed by CCPCs. Budget 2022 thereby provides for a new "Substantive CCPC" definition to include private corporations resident in Canada (other than CCPCs) that are ultimately controlled (in law or in fact) by Canadian-resident individuals. It would also cause a corporation to be a substantive CCPC in circumstances where the corporation would have been a CCPC, but for the fact that a non-resident or public corporation has a right to acquire shares. In addition, the new rules would be supported by a targeted anti-avoidance rule to address particular arrangements or transactions where it is reasonable to consider that the particular arrangement was undertaken to avoid qualifying as a substantive CCPC and the application of the refundable tax rules to investment income.

This measure would apply to taxation years that end on, or after April 7, 2022, and will provide exclusions to ensure genuine commercial transactions entered into before then are not affected.

Foreign Accrual Property Income Amendments

Foreign Accrual Property Income (FAPI) rules aim to prevent Canadian taxpayers from gaining a tax deferral advantage by earning certain types of income (including investment income) through controlled foreign affiliates (i.e., a non-resident corporation in which the taxpayer has, or participates in, a controlling interest). Budget 2022 proposes specific targeted amendments to maintain the integrity of these FAPI rules to ensure a tax-deferral advantage is not realized for certain CCPCs and their shareholders that earn passive investment income through non-resident foreign-controlled corporations.

Intergenerational Share Transfers

The *Income Tax Act* contains an anti-avoidance rule to prevent taxpayers from converting dividends into lower-taxed capital gains using certain self-dealing (or non-arm's length) transactions — a practice commonly referred to as "surplus stripping." This rule can often create a higher tax cost on the transfer of a business to a family member (and also prevent the ability to claim the Lifetime Capital Gains Exemption) versus a sale to a third-party purchaser. Private Member's Bill C-208, which received Royal Assent on June 29, 2021, introduced an exception to this anti-avoidance rule in order to facilitate intergenerational business transfers by paralleling the tax treatment accorded on an arm's length sale. However, the government had previously expressed concerns that the exception may unintentionally permit surplus stripping without requiring that a genuine intergenerational business transfer takes place.

Budget 2022 therefore announced a consultation process for stakeholders to share their views as to how the existing rules could be strengthened to protect the integrity of the tax system, while continuing to facilitate genuine intergenerational business transfers. The government indicated that it is committed to bringing forward the necessary legislation to address this specific issue, which could be tabled in the fall following the conclusion of the consultation process.

Small Business Deduction

Small businesses currently benefit from a reduced Federal corporate tax rate of 9 per cent on their first $500,000 of qualifying active small business income, compared to a general Federal corporate tax rate of 15 per cent. A business no longer has access to this lower rate once its level of capital employed in Canada reaches $15 Million, including any associated corporations. However, phasing out access to the lower tax rate too quickly can discourage some businesses from continuing to grow.

Accordingly, Budget 2022 proposes to phase out access to the small business tax rate more gradually, with access to be fully phased out when taxable capital reaches $50 Million, rather than at $15 Million.

This measure would apply to taxation years that begin on, or after April 7, 2022.

Employee Ownership Trusts

Employee ownership trusts encourage employee ownership of a business and facilitate the transition of privately owned businesses to employees. Last year's Federal Budget announced that the government would engage with stakeholders to examine what barriers exist to the creation of these trusts in Canada.

These consultations revealed that the main barrier to the creation of employee ownership trusts in Canada was the lack of a dedicated trust vehicle under current tax legislation tailored to the requirements of these structures. Accordingly, Budget 2022 proposes to create the Employee Ownership Trust — a new, dedicated type of trust under the *Income Tax Act* to support employee ownership.

The government announced that it will continue to engage with stakeholders to finalize the development of rules for the Employee Ownership Trust and to assess remaining barriers to the creation of these trusts.

Other Notable Corporate Tax Measures

- The introduction of a new 30 per cent Critical Mineral Exploration Tax Credit for specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors as part of a flow-through share agreement entered into after Budget Day and on, or before March 31, 2027;
- A proposed new investment tax credit for investments in clean technology of up to 30 per cent, focused on net-zero technologies, battery storage solutions, and clean hydrogen, the details of which will be provided in the 2022 Fall Economic and Fiscal Update;
- A new refundable investment tax credit for businesses that incur eligible Carbon capture, utilization, and storage (CCUS) expenses, starting in 2022;
- The phase out of the flow-through share regime for oil, gas and coal activities by no longer allowing these exploration and development expenditures to be renounced to flow-through share investors for flow-through share agreements entered into after March 31, 2023;

- A review to assess whether the tax system provides adequate support to investments in growing businesses, including an examination of the rollover for small business investments which allows investors in small businesses to defer tax on capital gains; and
- A review of the Scientific Research and Experimental Development program (SR&ED) to ensure that it is effective in encouraging R&D that benefits Canada, and to explore opportunities to modernize and simplify the program.

Measures Affecting Charities

There were limited, but important, measures in the Budget impacting charitable giving.

Disbursement Quota

Every year, charities are required to spend a minimum amount — termed the disbursement quota (DQ) — based on the value of their investment assets. As a result of consultations with the charitable sector following last year's Budget, the government proposes to introduce a new graduated DQ rate for charities. Specifically, for investment assets exceeding $1 Million, the rate of the DQ will be increased from 3.5 per cent to 5 per cent. Additional measures are proposed to clarify that expenditures for administration and management are not considered qualifying expenditures for the purposes of satisfying a charity's DQ.

Budget 2022 also proposes to provide the Canada Revenue Agency (CRA) discretion to grant a DQ reduction to certain charities applying for relief or for permission to accumulate property for a specific purpose for any particular tax year. The CRA will also improve the collection of information from charities, including whether charities are meeting their disbursement quota, and information related to investments and donor-advised funds held by charities.

These changes will be effective in respect of a charity's fiscal period beginning on, or after January 1, 2023, and will be reviewed after five years.

Charitable Partnerships

Budget 2022 proposes to allow greater flexibility for charities to support non-profit groups that may not have the ability to pursue charitable status of their own. Specifically, the Budget proposes to amend the *Income Tax Act* to allow a charity to provide its resources to organizations that are not qualified donees, provided that the charity meets certain requirements designed to ensure accountability.

Other Notable Measures

As in previous budgets, Budget 2022 continues the government's efforts to make legislative adjustments to help ensure that the tax system is functioning as intended and introduces certain measures to maintain the fairness and integrity of the tax system. In addition to those highlighted previously, other integrity and administrative measures include the following:

Strengthening the General Anti-Avoidance Rule

The general anti-avoidance rule (GAAR) is intended to prevent abusive tax avoidance transactions, while not interfering with legitimate commercial and family transactions. If abusive tax avoidance is established, the GAAR is applied to deny the tax benefit that was unfairly created.

Budget 2022 proposes to amend the *Income Tax Act* to provide that the GAAR can apply to transactions that affect tax attributes that have not yet been used to reduce taxes.

The government also intends to release in the near future a broader consultation paper on modernizing the GAAR, with a consultation period running through the summer of 2022, and with legislative proposals to be tabled by the end of 2022.

Reinforcing the Canada Revenue Agency

Building on recent investments, Budget 2022 proposes to provide $1.2 Billion over five years, starting in 2022-23, for the CRA to expand audits of larger entities and non-residents engaged in aggressive tax planning; increase both the investigation and prosecution of those engaged in criminal tax evasion; and to expand its educational outreach.

Strategic Policy Review

In addition to outlining the government's intention to review previously announced spending plans, Budget 2022 also highlighted a proposed Strategic Policy Review to assess program effectiveness in meeting the government's key priorities of strengthening economic growth, inclusiveness, and fighting climate change, and identify opportunities to save and reallocate resources to adapt government programs and operations to a new post-pandemic reality.

Employment Insurance (EI) Review

Budget 2022 announced a forthcoming consultation with Canadians on what needs to be done to build an Employment Insurance (EI) system that better meets the current and future needs of workers and employers, including simpler and fairer rules for workers, new ways to support experienced workers transitioning to a new career, and coverage for self-employed and gig workers.

Beneficial Ownership Registry

The government intends to accelerate its commitment to amend the Canada Business Corporations Act to implement a public and searchable beneficial ownership registry, which will now be accessible before the end of 2023.

Previously Announced Measures

Finally, Budget 2022 confirms the government's intention to proceed with many previously announced tax and related measures that have not yet been formally enacted, including the following notable measures affecting individuals and Canadian private companies:

- Legislative proposals relating to the Select Luxury Items Tax Act released on March 11, 2022;
- Legislative proposals released on February 4, 2022, including enhanced reporting requirements for certain trusts and the mandatory disclosure rules; and
- The anti-avoidance rules consultation originally outlined in the November 30, 2020 Fall Economic Statement.

Budget 2022 also reaffirmed the government's commitment to move forward as required with technical amendments to improve the certainty and integrity of the tax system.

The **2022 Federal Budget Review** was developed by our in-house tax professionals in the Wealth Planning and Advisory Services Group at BMO Private Wealth; **John Waters**, Vice-President, Director of Tax Consulting Services, and **Dante Rossi**, Director, Tax Planning. For more insights, visit **bmo.com/wealthinsights**

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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