2022 Federal Budget

Implications for Canadian Private Companies

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," contained significant spending initiatives focussed on housing affordability, child care, dental care, transition to a green economy, productivity and innovation. The Budget announced significant new spending, and anticipates a deficit of $113.8 Billion for fiscal 2021-22, a deficit of $52.8 Billion for 2022-23, with more modest deficit amounts thereafter.

From a personal tax perspective, 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 will become 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"), which is the focus of this review, 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.

The most significant income tax measures affecting 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.**

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

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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 upfront 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.

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.

For more information, ask your BMO financial professional for a copy of our publication, *Tax Relief Proposed for Intergenerational Transfers of Family Businesses*.

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;
- 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; and
- An accelerated 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.

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

This document is a summary of selected measures in 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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