CALU Special Report

Budget 2021: Government moves forward with its post-pandemic vision for Canada

Ottawa – April 19, 2021 - Finance Minister Chrystia Freeland tabled the Liberal Government's much anticipated 2021 budget. This *Special Report* highlights proposed government initiatives and tax proposals of greatest interest to our members and their clients. We extend our thanks to CALU tax advisors Kevin Wark and Angela Ross for their work in preparing this summary.

Highlights of Tax Proposals

Budget 2021 is perhaps as significant for what it doesn't do as for what it does from a tax policy perspective: No significant personal tax increases, wealth or estate taxes, changes to the taxation of capital gains, dividends and interest income, or changes to the principal residence exemption. Other highlights:

- No changes to the taxation of group insurance, exempt life insurance, corporate owned insurance or the capital dividend account
- No changes to section 84.1 designed to eliminate the inequitable tax treatment arising on the transfer of a shares in a private corporation from the owner to other family members
- No significant changes to the tax rules for private corporations including the TOSI and passive investment rules
- No new announcements/funding for a universal pharmacare program
- New limits on interest deductibility for corporations, trusts and partnerships with a carve out for certain private corporations
- A new tax on non-resident owners of "unproductive" Canadian housing
- A continued focus on aggressive tax planning strategies both domestically and internationally

Introduction

On April 19, 2021, Finance Minister Freeland tabled her first federal budget ("Budget 2021"), entitled "A Recovery Plan for Jobs, Growth, and Resilience." This is the first federal budget in over two years and contains a number of platforms and spending initiatives designed to address both pandemic-related issues and the government's vision for Canada post pandemic. At a whopping 724 pages, this budget not only addresses the current needs of a country labouring under the third wave of the pandemic but also establishes a number of new government programs including funding for a national childcare program. While it is unlikely this budget will topple the government, it does set the stage for a possible federal election in the fall. All told, this is a spending budget and not a taxing budget. Paying for the costs of pandemic spending and the new initiatives announced in Budget 2021 will likely be left for the next majority government.

This CALU *Special Report* provides information about tax proposals of greatest interest to CALU members.

Major Budget Themes

Budget 2021 outlines four major themes that will underpin the government's current and future priorities:

1. **Finishing the Fight Against Covid-19**
2. **Creating Jobs and Growth**
3. **A Resilient and Inclusive Recovery**
4. **Fair and Responsible Government**

By now most CALU members will have read or heard about many of the key policy positions and proposals. This report will focus on the fourth theme, Fair and Responsible Government, where most of the tax-related initiatives are contained.

What's Not Included in this Budget?

No Major Tax Increases, But…

As noted in the highlights section, there are no changes in marginal tax rates, the taxation of investment and insurance products, changes to the principal residence exemption or the introduction of a wealth tax. This is positive news. Having said that, Budget 2021 contains several proposals, discussed below, that could have a significant effect on specific taxpayers. And despite commentary on how low interest rates and economic growth will allow Canada to manage its growing debt, we must remain vigilant against growth-inhibiting tax increases. The CALU Tax Policy Committee has been formed to help establish CALU's priorities and positions on future tax changes. CALU is also a member of the Canadian Chamber of Commerce's "Think Growth" project, consisting of a team of industry leaders exploring ideas for harnessing Canada's tax system for inclusive recovery and growth. You can expect to hear more about these twin initiatives over the coming year.

Section 84.1 and Intergenerational Transfers of Business

CALU is disappointed that Budget 2021 does not contain any amendments or even an acknowledgement of the government's ongoing review of section 84.1 of the Income Tax Act (Canada) (the "Act") as it applies to family business transfers. This tax provision has been a major impediment to the successful transition of small businesses within a family – by either denying the business owner access to capital gains treatment on the business transfer (including denial of the capital gains exemption), or alternatively forcing the new family owners to assume potentially higher levels of debt to pay off the purchase price.

Starting in 2015 CALU began actively advocating for changes to section 84.1, culminating with the recent appearance of Chair Cindy David as a witness before the House Finance Standing Committee on Finance (FINA) hearing on a private member bill (Bill C-208) to amend section 84.1. Finance Canada officials also appeared before FINA to express concerns with the broad scope of the proposed amendments. We were therefore hopeful that the federal government would use the 2021 budget to introduce its own changes to section 84.1 to permit an exception for family business transfers.

Despite there being no commentary on section 84.1 in the budget documents, in a subsequent Tax Practitioners call with senior Finance officials, they did indicate that this issue continues to be on their radar. CALU will continue its advocacy efforts in support of small business owners who wish to preserve the family-owned business while minimizing unfair negative tax consequences.

Business Tax Measures

Interest Deductibility Limits[1]

The budget proposes to introduce a new rule, which will limit the amount of net interest expense that a corporation may deduct in computing its taxable income to no more than a fixed ratio of its 'tax EBITDA' (this is the corporation's taxable income before taking into account interest expense, interest income, income tax, and deductions for depreciation and amortization, where each of these items is as determined for tax purposes). The new rule will also apply to trusts, partnerships and Canadian branches of non-resident taxpayers.

The fixed ratio for the interest limitation will apply to existing as well as new borrowings and will be phased in as follows:

[1] This section is excerpted with permission from the PwC 2021 Federal Budget Report (Tax Insight from Tax Services Issue 2021-09). The complete PwC budget report can be accessed at https://www.pwc.com/ca/en/services/tax/budgets/2021/federal-budget-analysis.html

- fixed ratio of 40% for taxation years beginning on or after January 1, 2023 but before January 1, 2024 (the transition year)
- fixed ratio of 30% for taxation years beginning on or after January 1, 2024.

A "group ratio" rule will allow a taxpayer to deduct interest in excess of the fixed ratio, where the taxpayer can demonstrate that the ratio of net third party interest to book EBITDA of its consolidated group is higher than the fixed ratio; in this case, the interest limitation would be based on the higher group ratio.

Detailed legislative proposals are expected to be released for comment in the summer; however, the budget provided the following details with respect to the computation of tax EBITDA:

- tax EBITDA will exclude, among other things, dividends to the extent they qualify for the inter-corporate dividend deduction or the deduction for certain dividends received from foreign affiliates
- interest expense and interest income will include not only amounts that are legally interest, but also certain payments that are economically equivalent to interest, and other financing-related expenses and income
- interest expense will exclude interest that is not deductible under existing income tax rules, including the thin capitalization rules (which would continue to apply)
- interest expense and interest income related to debts owing between Canadian members of a corporate group will generally be excluded

Interest denied under the new interest limitation can be carried-forward for up to twenty years or back for up to three years (including carry-back to years before the introduction of the new rule, with some restrictions). In addition, a taxpayer (other than a bank or life insurance company) that is part of a group and that has excess capacity to deduct interest under the new rule can generally transfer this unused capacity to other Canadian group members.

Exemptions from the new rule will be provided for:

- CCPCs that, together with any associated corporations, have taxable capital employed in Canada of less than $15 million, and
- groups of corporations and trusts whose aggregate net interest expense among their Canadian members is $250,000 or less.

Immediate Expensing by CCPCs

To continue support for small businesses, Budget 2021 proposes to introduce temporary rules that will permit Canadian-controlled private corporations (CCPC) immediate expensing for "eligible property" (up to a maximum cost of $1.5 million per tax year) acquired on or after April 19, 2021 (the "Budget Day") so long as the property becomes available for use before January 1, 2024. This proposal will suspend the capital cost allowance (CCA) “half-year” rule that would otherwise limit the CCA claim on newly acquired property to one-half of the acquisition cost in the first year it became available for use. This proposal works together with other enhanced deductions under the existing CCA rules, including those announced in the 2018 Fall Economic Statement.

“Eligible property” for this measure will be capital property that is subject to the CCA rules other than those in classes 1 to 6, 14.1, 17, 47, 49, and 51 (long-lived assets).

Where used property is acquired, the proposals will only apply if the property was not previously owned by the taxpayer or a non-arm’s length person, and the property was not transferred to the taxpayer on a rollover basis.

Mandatory Disclosure Rules

In an effort to align with international recommendations for mandatory disclosure rules, and modelled after measures imposed under the U.S. and Australian tax rules, Budget 2021 is proposing a consultation process that could result in material enhancements to the current reportable transaction rules including:

- broadening the application of the reportable transaction rules
- introducing new requirements to report notifiable transactions
- introducing new requirements for specified corporations to report uncertain tax treatments, and
- extending the notice of assessment period and introducing penalties.

To the extent a proposal applies to a taxation year, it will apply to taxation years that begin after 2021; to the extent a proposal applies to a transaction, it will apply to transactions entered into on or after January 1, 2022. However, penalties will not apply to transactions that occur before Royal Assent.

Draft legislation and sample notifiable transactions are expected to be released in the coming weeks. Comments on the proposals are to be submitted by September 3, 2021. CALU will consult with members to determine the potential application of these proposals to client arrangements and determine whether a submission should be made part of the Finance Canada consultation process.

Reportable Transactions

Under the current rules, a transaction is a reportable transaction if it is an “avoidance transaction” (as defined for the purposes of the general anti-avoidance rule) and bears at least <u>two</u> of the following three hallmarks:

- a promoter or tax advisor is entitled to a contingency fee
- a promoter or tax advisor requires confidential protection (i.e., a non-disclosure agreement), and

- the taxpayer receives protection from a failure to achieve the intended tax result, or funding for the defense or dispute of the tax result.

Budget 2021 proposes to amend the rules so that they only require that the transaction bear one of the three hallmarks. The proposal will also amend the definition of "avoidance transaction" for these rules so that it includes a transaction if it is reasonable to conclude that one of the main purposes was to obtain a tax benefit.

In addition, where a taxpayer has a reportable transaction, it must be reported within 45 days of the earlier of the day the taxpayer enters into the transaction and the day the taxpayer is contractually obligated to enter into the transaction (compared to the current due date of June 30 in the calendar year following the year in which the transaction occurred).

Promoters and tax advisors will have reporting requirements with the same filing time limits with an exception to advisors where solicitor-client privilege applies.

Notifiable Transactions

To assist the Canada Revenue Agency (CRA) in identifying taxpayers who have implemented specific tax schemes, Budget 2021 proposes to add rules for the disclosure of notifiable transactions, which will include both transactions the CRA has found to be abusive, and transactions of interest.

A taxpayer who enters into a notifiable transaction, or transactions that are substantially similar to a notifiable transaction, will be required to report the transaction in prescribed form within 45 days of the earlier of the day the taxpayer enters into the transaction and the day the taxpayer is contractually obligated to enter into the transaction.

Promoters and tax advisors will have reporting requirements with the same filing time limits with an exception to advisors where solicitor-client privilege applies.

The Minister of National Revenue will have the authority to designate a transaction that is a notifiable transaction (with the concurrence of the Minister of Finance). The description of a notifiable transaction will set out details on the fact patterns and outcomes, along with examples, to enable the determination of whether a particular transaction is a notifiable transaction.

It should be noted that Quebec already has similar rules in place for taxpayers undertaking "prescribed transactions."

Uncertain Tax Treatments

For public corporations, and private corporations that choose to have audited financial statements prepared in accordance with the International Financial Reporting Standards (IFRS), Budget 2021 proposes a requirement to report particular uncertain tax treatments in a taxation year where the following conditions are met:

- the corporation is required to file a Canadian income tax return for the year
- the corporation has at least $50 million in assets at the end of the year as disclosed in its balance sheet (this threshold applies to each corporation)
- the corporation, or a related corporation, has audited financial statements prepared in accordance with IFRS (or similar foreign GAAP), and
- the audited financial statements reflect uncertainty in the Canadian tax provision.

For each uncertain tax treatment, the corporation will be required to provide prescribed information such as the amount of tax at issue, a description of the facts, the tax position taken, and whether the uncertainty is with regard to a permanent or temporary tax difference. This disclosure will be due at the same time as the corporation's Canadian income tax return.

Reassessment Period and Penalties

Budget 2021 proposes that where there is an obligation under the new mandatory disclosure rules, the taxpayer's normal reassessment period will not begin until the taxpayer has made the required disclosure. For taxpayers who do not disclose as required, this means the taxation year will not become statute barred.

In addition, for taxpayers who enter into a reportable or notifiable transaction, there will be a penalty for a failure to disclose equal to:

- for corporations with at least $50 million in assets, $2,000 per week, up to the greater of $100,000 and 25% of the tax benefit, or
- otherwise, $500 per week, up to the greater of $25,000 and 25% of the tax benefit.

For uncertain tax treatments, the penalty for each uncertain tax treatment will be $2,000 per week to a maximum of $100,000.

For promoters and advisors, a failure to disclose a reportable or notifiable transaction will result in a penalty (for each failure) equal to the total of:

- 100% of the fees charged to the entity that received the tax benefit
- $10,000, and
- $1,000 for each day of failure to a maximum of $100,000.

For taxpayers who may be subject to both taxpayer and promoter/advisor penalties, only the greater of the two penalties will apply.

Personal Tax Measures

Tax on Luxury Items

Budget 2021 proposes to introduce a tax on the purchase of new luxury cars (value over $100,000), personal planes (value over $100,000) and boats (value over $250,000), effective for purchases made on or after January 1, 2022. The tax amount will be the lesser of 10% of the purchase price (excluding GST/HST and/or provincial sales tax) and

- for luxury cars and personal planes, 20% of the purchase price in excess of $100,000, and
- for boats, 20% of the purchase price in excess of $250,000.

There are a number of exceptions to the vehicles that will be subject to this tax, but generally the proposed new tax will apply to any personal use vehicle where the purchase price exceeds the noted threshold.

GST/HST will continue to apply to the final sale price of the vehicle, which will include the proposed new tax, increasing the overall impact of this measure. For example, if a luxury car price is $150,000, the proposed new tax will be $10,000 (lesser of 10% of $150,000 and 20% of $50,000) plus the GST/HST on the $10,000 ($1,300 HST in Ontario).

Disability Tax Credit

Budget 2021 proposes to expand the criteria for disabled persons to qualify for the disability tax credit (DTC). Commencing in the 2021 taxation year (for DTC certificates filed after Royal Assent) the following changes will be made to the DTC eligibility criteria:

- There will be an expanded list of mental functions that are deemed necessary for everyday life
- There will be further clarity on the types of activities that will be used in calculating time spent in therapy
- The daily requirement for therapy will be reduced from three times to two times a week (but there is no change in the requirement for 14 hours of weekly therapy).

Contributions to Defined Contribution Pension Plans

The Act currently does not permit defined contribution pension plans (DC plans) to accept contributions made to correct a contribution error made in a prior taxation year. Budget 2021 proposes to permit the rectification of contribution errors for DC plans as follows:

- Additional contributions will be permitted to an employee account for an under-contribution error made in the preceding five years (there will be a specified dollar limit cap that is yet to be determined)

- A refund may be made to the employee or employer contributor to reverse an over-contribution error made in the preceding five years
- The plan administrator will be required to report the error on a prescribed form rather than being required to issue an amended T4 slip for the affected years.

To the extent that the rectification of the error affects the plan member's RRSP contribution room, such corrections will only impact RRSP room on a go-forward basis. The new measures are to be effective in respect of corrections in errors implemented in 2021 and subsequent taxation years, which would mean that errors occurring in 2016 and subsequent taxation years may be rectified in 2021 under the new rules.

Increasing Old Age Security for Canadians 75 and Over

Budget 2021 proposes to provide a *taxable* grant payment of $500 to Old Age Security pensioners who will be age 75 or older as of June 2022 (Note - the seniors grant payment in 2020 was not taxable). However, this payment will be exempted from the definition of income for purposes of the claw-back under the Guaranteed Income Supplement.

It is also proposed that the maximum benefits payable to Old Age Security pensioners age 75 or older be increased by 10% effective July 1, 2022. This increase would provide additional benefits of $766 to full pensioners in the first year, indexed to inflation. If a taxpayer is receiving higher OAS payments due to a deferral past age 65, the 10% increase will apply to the higher amount.

Other Announcements and Measures of Interest

Tax on Unproductive Use of Canadian Housing

Starting in 2023, a new tax will be imposed equal to 1% of the value of Canadian residential real estate owned by non-residents of Canada where such properties are considered vacant or "underutilized." To give effect to such a tax, owners of residential property in Canada who are not Canadian citizens or permanent residents (a "non-resident") will be required to file an annual declaration for each residential property they own. In such declaration the non-resident will need to report the value of the property and, if applicable, claim an exemption from the tax based on a qualifying use of the property. Failure to file the declaration will result in interest, penalties and an unlimited assessment period.

Budget 2021 indicates that Finance Canada plans to release a backgrounder and engage in a consultation with stakeholders on such issues as the definition of residential property, how the tax will apply on property owned by multiple individuals and non-individuals, determining the value of such property for purposes of this tax, and how the tax would apply where the property is located in smaller resort and tourist communities. It is estimated this measure will increase federal revenues by $700 million over four years, starting in 2022-23.

Calculation of Disbursement Quotas for Charities

As one of the measures to address the growing funding needs for Canada's charities, Budget 2021 proposes to launch a public consultation with charities on increasing the disbursement quota with the goal of having new rules in place beginning in 2022. It was noted that Canada's charitable foundations hold over $85 billion in long-term investments (i.e., not being deployed on charitable activities) which has been growing substantially over the past number of years at a pace greater than what is being deployed.

Tax Services and Compliance Measures

To further support the Canada Revenue Agency's audit, service and security capabilities, Budget 2021 proposes to make the following investments in three key initiatives:

- $230 million over five years to improve its ability to collect outstanding tax debts
- $330 million over five years to invest in new technologies, tools and IT infrastructure to deal with cyber threats and improve the way benefits and services are delivered to taxpayers
- $88 million over four years to further improve the delivery of tax digital services to taxpayers

Strengthening Beneficial Ownership Reporting

Building on the transparency rules that have been added to, or proposed for, the federal and a number of provincial corporate laws, Budget 2021 proposes to spend $2.1 million over the next two years to put in place a publicly accessible corporate beneficial ownership registry by 2025. This measure continues the Canadian government's commitment to corporate transparency to enhance the battle against money laundering, tax evasion, and other financial crimes.

Avoidance of Tax Debts

Section 160 of the Act contains rules that can result in joint and several tax liability for the transferor and transferee of property, where such property is transferred to a non-arm's length person or to certain family members for consideration less than fair market value, and the transferor had an outstanding tax liability that arose prior to the end of the taxation year of the transferor. However, recent tax cases involving certain corporate transactions have exposed gaps in the rules that would permit taxpayers to effectively avoid the application of section 160 and absolve the transferee from joint tax liability for existing or future tax debts of the transferor.

Effective for transfers of property made after April 18, 2021, Budget 2021 proposes to introduce a specific anti-avoidance rule to deal with these types of planning opportunities. The rule will provide that for the purposes of section 160 (and other relevant provisions of the Act), a tax debt will be deemed to have arisen before the end of the taxation year in which the transfer of property took place if it is reasonable to conclude that:

- The transferor (or a non-arm's length person) had knowledge (or should have known had they made reasonable inquiries) that there would be a tax amount owing by the transferor (or there would be except for the additional tax planning) that would arise after the end of the year, and
- One of the purposes for the transfer was to avoid the payment of the future tax debt.

Budget 2021 also proposes rules that, in certain cases where a purpose test is met, will deem the transferee and transferor to be dealing not at arm's length at the time of the transfer. The provision will also consider the overall result of the transaction in determining the value of the property transferred and the consideration given.

The new rules will also impose penalties for planners and promoters of these types of transactions – with the penalty being the lesser of $100,000 plus the promoter/planner fees, and 50% of the tax that is attempted to be avoided.

Status of Prior Announced Measures

Budget 2021 also indicates that the government still plans to move ahead with the following:

- Consultations on the general anti-avoidance rule (GAAR) announced in the 2020 Fall Economic Statement
- The income tax measures relating to registered disability savings plans and employee stock options announced in the 2020 Fall Economic Statement
- Measures announced in Budget 2018 to facilitate the conversion of Health and Welfare Trusts to Employee Life and Health Trusts (ELHTs) [Note – CALU is in the process of making further submissions to Finance Canada relating to the draft proposals governing ELHTs released in November 2020]
- Legislation released on July 30, 2019 relating to advanced life deferred annuities ("ALDA") (permitted under RRSPs, RRIFs, DPSPs, PRPPs and defined contribution RPPs); and variable payment life annuities ("VPLA") (permitted under PRPPs and defined contribution RPPs)
- Income tax measures announced in Budget 2018 to implement enhanced reporting requirements for certain trusts to provide information on an annual basis.

Budget 2021 also reaffirms the government's commitment to move forward as required with technical amendments to improve the certainty and integrity of the tax system.

In Conclusion

CALU will continue to monitor and report on the implementation of the budget measures and will make submissions to Finance on those proposals of importance to our members.

For questions and further information relating to Budget 2021 please contact Kevin Wark, CALU Tax Advisor at kwark@calu.com.