Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

Davidson & Company LLP
Chartered Professional Accountants

Personal Tax Rates
2022 Marginal Tax Rates in B.C.

Taxable Income *	Salary & Interest	Capital Gains	Non-Eligible Dividends [a]	Eligible Dividends [a/b]
$ 11,302 - 43,070	20.1%	10.0%	10.4%	0.0%
$ 43,071 - 50,197	22.7%	11.4%	13.5%	0.0%
$ 50,198 - 86,141	28.2%	14.1%	19.8%	7.6%
$ 86,142 - 98,901	31.0%	15.5%	23.0%	7.6%
$ 98,902 - 100,392	32.8%	16.4%	25.1%	8.0%
$ 100,393 - 120,094	38.3%	19.1%	31.4%	15.6%
$ 120,095 - 155,625	40.7%	20.4%	34.2%	18.9%
$ 155,626 - 162,832	44.1%	22.0%	38.1%	23.5%
$ 162,833 - 221,708	46.2%	23.1%	40.5%	26.4%
$ 221,709 - 227,091	49.8%	24.9%	44.6%	31.4%
$ 227,092 and up	53.5%	26.8%	48.9%	36.5%

a Effective rates are based off of actual cash dividends. Use 1.15 of the cash non-eligible dividend and 1.38 of the cash eligible dividend to determine the tax bracket.
b The rates disregard the possible application of alternative minimum tax (AMT).
* The additional basic personal amount of $1,679 for 2022 is phased out on a straight-line basis starting at taxable income of $155,626 and fully eliminated at $221,708

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2022 Corporate Tax Rates
For December 31st Y/Es

Combined Fed. & B.C. Tax Rates for Business Income

Sm. Bus. up to $500K	General Bus. rate
11.0%	27.0%

Combined Fed. & B.C. Tax Rates for Invest. Income/Capital Gains

	CCPC	Non-CCPC
Interest/Rents/Royalties	* 50.7%	27.0%
Capital Gains	** 25.4%	13.5%
Dividends	*** 38.3%	*** 38.3% [a]

* 30 2/3% tax is refundable when sufficient dividends are paid. ** 15 1/3% tax is refundable when sufficient dividends are paid
*** fully refundable when sufficient dividends paid

a Applies to non-CCPC private corporations

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Did you know? Each year, certain personal income tax and benefit amounts are indexed to inflation using the Consumer Price Index data as reported by Statistics Canada. Increases to tax bracket thresholds, amounts relating to non-refundable credits, and most other amounts below take effect on January 1 of the applicable year.

U.S. TAX CORNER

Mandatory Capitalization of Research & Development Expenses

Despite lobbying by many Fortune 100 companies and strong bi-partisan support to retain the deductibility of research and development (R&D) costs, 2022 brings an unexpected change for companies in the manufacturing, technology, SaaS, and life sciences industries. Those companies with significant R&D costs, including software development costs, will now be subject to mandatory capitalization, for U.S. tax purposes, as an intangible asset. This can have a significant impact on their 2022 financial statements and cash flows, as they will no longer be allowed to deduct those expenses in the year incurred.

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For businesses with multi-national operations, the amortization period is over a five or fifteen-year period, depending on whether the research was conducted in the U.S. or outside the U.S., respectively. This will be treated as an automatic change in accounting method, and will not require a Form 3115. The mandatory capitalization of R&D expenses may also impact other U.S. federal tax computations, including Sec. 163(j) business interest expense limitations, GILTI and foreign tax credits. Another important attribute is that the amortization is not terminated in the case of retirements, abandonment or disposal, but will continue through the full five or fifteen-year period.

Many U.S. tax practitioners had predicted that the mandatory capitalization would be at least postponed, as was initially passed by the House in the Build Better Act ("BBA") in late 2021. However, the BBA, which included legislation to delay the mandatory capitalization of R&D expenses, has since stalled in the Senate.

Companies now need to start reviewing their Sec. 174 R&D expenses, which includes "all costs incidental to the development or improvement of a product" and consider the impact of mandatory capitalization on their 2022 quarterly provisions and Federal tax estimated payments. There may also be opportunities to amend recent tax returns to capture prior unclaimed R&D tax credits. If you have questions on how this 2022 change affects your business, and to stay updated with any attempted amendments to the law, please contact Namir Hallak at: nhallak@davidson-co.com

FEDERAL BUDGET HIGHLIGHTS

On April 7, 2022, the Federal government released its annual budget (they missed 2021 because of the pandemic), which included various income tax measures. Below is a summary of some of the more significant measures.

As is often the case, there was no detailed draft legislation (technically a "Notice of Ways and Means Motions") for many of the tax proposals. As a result, the discussion below relies largely on the comments made by the Department of Finance in the budget documents.

Tax-Free First Home Savings Account

The government introduced a Tax-Free First Home Savings Account ("**FHSA**"), which is meant to assist first-time home buyers. The account is available to residents of Canada who are at least 18 years old and have not lived in another owned home in the year the account is set up or during the four preceding years.

Your contributions to the FHSA will be deductible in computing your income, and all income earned in the account will be tax-free. Furthermore, withdrawals from the FHSA will not be included in income as long as the withdrawn funds are used to buy a home and not for other purposes.

The lifetime limit on contributions to the FHSA will be $40,000, with an annual contribution limit of $8,000, which will begin in 2023.

The Budget papers state that "to provide flexibility", you will be able to transfer funds from your FHSA to a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) on a tax-free basis (and it will not reduce your regular RRSP deduction room). However, like other withdrawals from an RRSP or RRIF, when the amounts are subsequently withdrawn from the RRSP or RRIF, they will be included in your income.

Conversely, you will be allowed to transfer funds from your RRSP to your FHSA on a tax-free basis, but as an "eligible person" – generally, a person who is 65 or older, or an adult who is 18 or older and who qualifies for the disability tax credit. The renovation must be made for the purpose of having the eligible person live with a "qualifying relation", which includes a person who is 18 years old or more and is a parent, grandparent, child, grandchild, brother, sister, aunt, uncle, niece or nephew of the eligible person.

The purpose of the credit is to assist in situations where the eligible person lives or moves in with the qualifying relation, and a construction addition to the home, or secondary dwelling unit, is made to the home for the living space of the eligible person.

The credit will be 15% of eligible renovation expenses, capped at a maximum of $50,000 of expenses (i.e., maximum $7,500 credit).

The Budget documents indicate that the credit can be claimed by the eligible person or their spouse or common-law partner, or the qualifying relation. Alternatively, it can be shared among these persons, although the total of renovation expenses that can be claimed by all of them remains capped at $50,000.

The home must be owned by the eligible person, the spouse or common-law partner of the eligible person or the qualifying relation. Additionally, it must be a home where the eligible person and the qualifying relation ordinarily reside, or intend to ordinarily reside within 12 months after the renovation period. The credit is claimed in the year in which the renovation period ends.

As with the Tax-Free First Home Savings Account, we expect more details from the government in the near future.

First-Time Home Buyers' Tax Credit

The existing First-Time Home Buyers' non refundable tax credit will double to $10,000 for the purchase of a qualifying home in Canada, effective for home purchases on or after January 1, 2022.

Home Accessibility Tax Credit

This credit has been around since 2015. It has been 15% of up to $10,000 of eligible expenses relating to a home, generally meaning expenses to assist a senior person or disabled person to have more mobility and access to the home (for example, wheel chair ramps, and generally repairs or renovations that improve the person's accessibility around the home).

The Budget increased the dollar limit to $20,000, effective as of 2022.

Residential Property Flipping Rule

This rule, effective starting in 2023, proposes to apply where you buy a residential home, including a rental property, and sell it within 12 months. If the rule applies, the full profit you make will be included as business income, rather than the 50% inclusion amount for capital gains. In addition, you will not qualify for the principal residence exemption. This is an arbitrary rule, perhaps meant to cool down the housing market, but will not really change the law, since the CRA has for many years been treating sales after less than a year as being business income, and Courts have upheld the CRA's position in most cases.

There are several exceptions to this rule where your sale or disposition of the home results from certain "live events". The exceptions will include:

- *Death:* a disposition of the property because or in anticipation of your death or that of a related person.
- *Household addition*: a disposition because of a related person joining your household, or you joining a related person's household.
- *Separation*: a disposition because of the breakdown of your marriage or common-law partnership.
- *Personal safety*: a disposition because of a threat of your personal safety, such as the threat of domestic violence.
- *Disability or illness*: a disposition resulting from you or a related person having a serious disability or illness.
- *Employment change:* a disposition because you or your spouse or common-law partner move to work at a new location, or because of an involuntary termination of your employment. In the case of work at a new location, your new home must be at least 40 kilometres closer to the new work location than was your old home.
- *Insolvency*: a disposition because of insolvency, or to avoid insolvency.

Medical Expenses Related to a Surrogate Mother or Sperm, Ova or Embryo Donor

Under current rules, certain expenses relating to ***in-vitro*** procedures are eligible for the medical tax credit. The Budget broadens the types of expenses that qualify. This change applies to 2022 and subsequent years. For example, the credit will apply to reimbursements paid to a surrogate mother for her expenses, and expenses for an ***in-vitro*** fertilization procedure or prescription medication related to her pregnancy. The credit will also be allowed for fees paid to fertility clinics and donor banks to obtain donor sperm or ova.

Reporting Requirements for RRSPs and RRIFs

Under current rules, financial institutions must report your withdrawals from registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) to the Canada Revenue Agency (CRA). However, they are not required to report the value of these plans.

Beginning in 2023, the institutions will be required to report the fair market value of your plans to the CRA as of the end of the year. According to the Budget, the rationale for this new rule is to "assist the Canada Revenue Agency in its risk-assessment activities regarding qualified investments held by RRSPs and RRIFs." In other words, if you have a very high value in your RRSP (such as due to having invested in stocks that multiplied many times), the

CRA wants to review it and make sure that it has not invested in non-qualified or prohibited investments.

Flow-through shares

In general terms, flow-through shares allow investors / shareholders to claim a deduction or credit in respect of certain qualifying expenses incurred by a corporation. The corporation "renounces" the expenses to the investor, who then gets the tax benefit.

The Budget introduced a new **30% Critical Mineral Exploration Tax Credit** for businesses investing in certain minerals. The minerals that will qualify include copper, nickel, lithium, cobalt, graphite, rare earth elements, scandium, titanium, gallium, vanadium, tellurium, magnesium, zinc, platinum group metals and uranium. The new credit applies to flow-through share agreements entered into after April 7, 2022 and on or before March 31, 2027.

At the same time, the Budget **eliminated the flow-through share treatment for oil, gas, and coal** expenses incurred by a corporation. As a result, a corporation will not be allowed to renounce oil, gas and coal exploration or development expenditures to a flow-through investor. This change will apply to flow-through share agreements entered into after March 31, 2023.

Small Business Deduction

The small business deduction allows certain Canadian-controlled private corporations (CCPCs) to pay a preferential rate of tax on up to $500,000 of active business income per year. The federal tax rate is 9%, and the provincial rate depends on the province.

Under current rules, the small business deduction is phased out starting when the CCPC has taxable capital in excess of $10 million, and is totally eliminated once its taxable capital is $15 million or more.

The Budget allows a more gradual phase-out. Although the deduction is still phased out starting when the CCPC has taxable capital over $10 million, the phase out will occur between that amount and $50 million of taxable capital. This new rule applies to taxation years beginning on or after April 7, 2022.

The Budget provides the following examples:

- a CCPC with $30 million in taxable capital would have up to $250,000 of active business income eligible for the small business deduction, compared to $0 under current rules; and
- a CCPC with $12 million in taxable capital would have up to $475,000 of active business income eligible for the small business deduction, compared to up to $300,000 under current rules.

Amendment to the general anti-avoidance rule ("GAAR")

The GAAR allows the CRA (or ultimately the courts) to adjust certain tax attributes of a taxpayer. The GAAR can apply where you undertake an avoidance transaction (subject to other conditions). Generally, an avoidance transaction is one that provides you with a tax benefit, unless it was undertaken primarily for bona fide purposes other than to get the tax benefit.

The Budget extends the GAAR as a response to a Federal Court of Appeal decision which narrowed its scope. In that decision, the Court of appeal held that the GAAR did not apply to a transaction that resulted in an increase in a tax attribute in a previous year that had not yet been used to reduce taxes in a current year.

The Budget addressed this issue, and provides that the GAAR can apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax. This change is effective for notices of determination issued by the CRA on or after April 7, 2022.

Substantive CCPCs

As noted earlier, a CCPC is taxed at a preferential rate on business income owing to the small business deduction.

However, it is taxed at very high rates (typically around 50% or more) on its investment income, including taxable capital gains. The CCPC does get a significant refund of the tax if and when it pays a dividend to its shareholders.

However, a corporation that is not a CCPC is not subject to those high rates on investment income. The government is concerned that some taxpayers are structuring their private corporations to deliberately fall outside of the CCPC high rates on investment income.

For example, the Budget papers indicate that some taxpayers may seek to avoid CCPC status by continuing a corporation under foreign corporate law, while maintaining Canadian residency.

As a result, the Budget proposes that "substantive CCPCs" be subject to the same income tax regime for investment income that applies to regular CCPCs. Generally, a substantive CCPC will be a private corporation resident in Canada that is not a regular CCPC, but is ultimately controlled by Canadian-resident individuals. Other conditions apply. In most cases, this new rule applies to taxation years that end on or after April 7, 2022.

International Tax Reform

The Budget indicated Canada's willingness to adopt the two "pillars" of the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting initiative (known as the "BEPS"), which is intended to reduce tax avoidance for multi-national enterprises.

The proposals are quite complex. In general terms, as the Department of Finance explains:

"Pillar One is intended to reallocate a portion of taxing rights over the profits of the largest and most profitable multinational enterprises (MNEs) to market countries (i.e., where their users and customers are located). Pillar Two is intended to ensure that the profits of large MNEs are subject to an effective tax rate of at least 15%, regardless of where they are earned."

More details are expected in the near future. The government has asked prospective stakeholders for their comments and consultation.

LOW OR NO-INTEREST EMPLOYEE LOANS

If you receive a loan from your employer, you may be subject to tax on an "imputed interest" inclusion in your income.

Basically, the amount included in your income for a year will be the amount by which the prescribed rate of interest on the loan during the year exceeds the amount of interest, if any, that you paid on the loan in the year or by January 30 of the following year. For the current quarter of 2022 (April 1 to June 30), the prescribed rate is 1%.

Example

On January 1 of a particular year, you received an interest-free loan of $100,000 from your employer. We will assume the prescribed rate of interest for the first half of the year is 1% and 2% for the second half.

Your income inclusion will equal 1% of $100,000 x ½ (since only half of the year) plus 2% of $100,000 x ½.

So you would include $500 plus $1,000, or $1,500, in your income for tax purposes. As noted above, if you ended up paying some or all of the interest, the inclusion would be reduced accordingly.

There is an exception to the rule, which basically says that if you pay a reasonable arm's length rate of interest on the loan, there is no income inclusion for you.

So that's the downside of the rule.

There is a potential upside, if you use the loan for the purpose of earning investment income or business income. In such case, you get an offsetting deduction equal to the interest – so in the above example, you would get an offsetting deduction of $1,500. You can also can claim a deduction if you use the loan to purchase a motor vehicle used in your employment duties, but in such case the amount of the deduction will be pro-rated based on your employment use of the vehicle relative to your personal use (since the personal portion is not deductible).

Home purchase loan

If you use the loan to purchase a home in which you live (so this doesn't include a property you rent out to someone else), the prescribed interest rate is capped at the rate at the time of the loan. The cap lasts for 5 years. If the loan remains outstanding after 5 years, then a new cap kicks in based on the prescribed rate of interest at that time.

So if the prescribed interest rate increases over time, you will only be taxed on the lower prescribed rate that was in effect at the time of the loan. Right now – April through June 2022 – is likely the last quarter that the rate will be at 1% (as it has been since July 2020), as interest rates are rising.

Forgiveness of loan

If your employer subsequently forgives the repayment of the principal amount of the loan, then the remaining unpaid principal amount is fully included in your income. Although that result might seem a bit harsh, the rationale is that your employer gave you some money, which you didn't have to repay, so that it's similar to them giving you extra remuneration for your work.

COMPUTATION OF BUSINESS PROFIT

There are major differences between income tax rules and financial accounting rules.

However, in one area, there is significant overlap. That area is the computation of business income or profit.

Thus, for income tax purposes, in most cases the basic rule is that you start with the net income or profit for financial accounting purposes. But, since there are still some differences between the tax and accounting rules, you make adjustments based on those differences. For example, if an amount is deductible for accounting purposes but not deductible for tax purposes, you add back that amount when converting the accounting business income to income for tax purposes. Or if an amount is deductible for tax purposes but not accounting purposes, then you deduct that amount when converting from accounting to income for tax purposes.

A few of the differences between business income for tax purposes and accounting purposes include:

- Depreciation or amortization for accounting purposes is not allowed for tax purposes. Instead, you use the capital cost allowance provisions under the Income Tax Act.
- For meals and entertainment expenses incurred for business purposes, in most cases only 50% of the expenses are deductible for tax purposes. There is no similar rule for accounting purposes.
- Government fines and penalties, even if incurred in the course of your business, are not deductible for tax purposes.
- For motor vehicle expenses, there are arbitrary dollar limits for tax purposes.
- Landscaping and site investigation costs are deductible in full in the year they are paid for tax purposes. For accounting purposes, they are sometimes amortized, depending on the facts.
- For tax purposes, you cannot deduct amounts paid for the use of a golf club, or membership fees paid to a recreational club.
- If a corporation issues new shares or debt, its financing costs (e.g. investment bank and legal fees) are amortized over five years for tax purposes. There is no similar rule for accounting purposes.

* * *

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