BUDGET 2022: NEW INVESTMENT INCOME ANTI-DEFERRAL MEASURES - INTRODUCING THE "SUBSTANTIVE CCPC"

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Canadian federal income tax rules generally seek to achieve "neutrality" between "investment income" (including interest, rents, royalties, capital gains, and "foreign accrual property income" or "FAPI') earned directly by Canadian-resident individuals versus through private corporations they control. This objective is primarily effected by the imposition of additional refundable taxes on certain private corporations in the year that investment income is earned. Absent the refundable tax regime, investment income earned by a private corporation would be subject to tax at a rate (generally 23% – 31%) that is materially lower than the highest marginal tax rate applicable to individuals (generally 44.5% to 54%).

Historically, the refundable tax provisions have only applied to "Canadian-controlled private corporations" or "**CCPCs**", as defined in the *Income Tax Act* (Canada) (the "**ITA**"). CCPCs are very broadly defined as generally encompassing private corporations that were incorporated under Canadian federal or provincial law and that are not factually controlled by non-residents or public corporations.

In recent years, the government has come to believe that the foregoing neutrality principle is being circumvented (resulting in perceived inappropriate tax deferrals) by way of arrangements designed to cause a corporation to lose its CCPC status, with the corporation thereafter earning investment income while continuing to (a) qualify as a Canadian resident, and (b) remain under the control (whether directly or indirectly, and whether legally or factually) of Canadian residents. Budget 2022 suggests that such arrangements include those that entail a change in status of a corporation in anticipation of capital gains arising from an asset sale transaction (by way of, for example, the signing of a purchase agreement with a non-resident buyer, or by continuing the corporation to a jurisdiction outside of Canada).

To curb the perceived deferral advantage arising from such arrangements, Budget 2022 introduces a "substantive CCPC" concept, which, as the name suggests, is designed to apply the refundable tax regime to investment income earned by any company that falls outside the technical definition of a CCPC *but is "in substance"* a CCPC. The announced measures attempt to align the taxation of investment income earned and distributed by "substantive CCPCs" with the rules that currently apply to CCPCs.

Under the Budget proposals, “substantive CCPCs” are defined as private corporations resident in Canada (other than CCPCs) that are ultimately controlled (in law or in fact) by Canadian-resident individuals. Similar to the CCPC definition, the test to determine “substantive CCPC” status will contain an extended definition of control aggregating shares owned, directly or indirectly, by Canadian resident individuals (with the result that a corporation would be deemed to be controlled by a Canadian resident individual where Canadian individuals own, in the aggregate, sufficient shares to control the corporation). Furthermore, the investment income earned by substantive CCPCs would be added to the corporation’s “low rate income pool” such that subsequent distributions of the income from the corporation would not entitle the shareholders to claim the enhanced dividend tax credit.

While Budget 2022 indicates that the substantive CCPC measures are not intended to affect “genuine non-CCPCs” (which Budget 2022 indicates, by way of example, include “private corporations that are ultimately controlled by non-resident persons and subsidiaries of public corporations”), it nevertheless confirms that substantive CCPCs will include corporations that “would have been a CCPC but for the fact that a non-resident or public corporation has a right to acquire its shares”. Furthermore, Budget 2022 proposes the introduction of an anti-avoidance rule that will provide that non-CCPCs falling outside the substantive CCPC definition will nevertheless be accorded substantive CCPC status where it is reasonable to consider that one of the purposes of a transaction, or series of transactions, was to avoid such status.

It is noteworthy that the substantive CCPC rules, as proposed, would only apply to the integration of investment income taxation described above – meaning that a substantive CCPC would not be entitled to other benefits under the ITA reserved for CCPCs, including access to the lower rate of taxation offered through the “small business deduction”, and entitlements under the refundable investment tax credit rules for research and development contained in section 127.1 of the ITA.

The substantive CCPC measures in Budget 2022, if enacted, would apply to corporate taxation years ending on or after the Budget Date (April 7, 2022), subject to an exception for what the government refers to as “genuine commercial transactions” entered into before the Budget Date, where the taxation year of the subject corporation ends because of an “acquisition of control” caused by the sale of all or substantially all of the shares of a corporation to an arm’s length purchaser that is “entered into” before the Budget Date and completed before the end of 2022. The foregoing coming into force measures may raise certain interpretive questions as to the types of arrangements that would constitute a qualifying “purchase and sale agreement” for this purpose, including an agreement styled as a “letter of intent”.

Finally, it is noted that, to facilitate the administration of the proposed substantive CCPC measures, including the earning and distribution of income by such entities, Budget 2022 provides for a one-year extension of the “normal reassessment period” in certain circumstances.

In summary, the proposed substantive CCPC rules could, if enacted, impact a number of the planning techniques traditionally employed by Canadian-owned groups, including, most significantly, in the M&A context.

by Todd Miller

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.