Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

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Federal Budget 2022

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As the economic effects of the pandemic fade, the Canadian government is trying to navigate a fine line between delivering on spending commitments it made during the election and to the NDP, while reining in the extraordinary outlays that were introduced in the heart of the pandemic. This year's budget focuses on support for housing and defense, delivers a much-anticipated dental care plan, and shifts the trajectory of fiscal policy toward normalization.

The 2022 fiscal plan is a less expansive budget than expected for the first year following the re-election of the Liberal government. While delivering on key promises it also demonstrates some commitment to returning spending back toward pre-pandemic norms. With major new spending initiatives worth $31 billion over the next five years, the near-term focus is on improving affordability while largely avoiding addressing the longer-term structural issues that weigh on growth.

New initiatives include:

- A widely-expected commitment on a **dental care program**, targeted toward those earning less than $90,000 per year. Full implementation is expected to occur over a multi-year timeframe beginning with those under the age of 12, with $5.3 billion in dedicated support for the program as it ramps up over a 5-year period.
- $8 billion dollars in **spending to bolster Canada's national defence.** This includes a policy review aiming to enhance the size and capability of the Canadian Armed Forces in light of the changing international landscape. It also includes a commitment to cyber security, as well as increasing its commitments to NATO and NORAD. The budget also includes over $1 billion in additional support for Ukraine.
- A **focus on affordability in housing**, Including programs designed to speed up the creation of new housing as well as providing tax support for those renovating multi-generational homes. As part of this, new measures were introduced to ban the foreign purchase of residential property for a two-year period. A new First Home Savings Account was also tabled, wherein first-time home buyers will be able to save $40,000 towards the purchase of a new

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home on a taxfree basis through an account structured like a hybrid RRSP and TFSA.

- Measures to support spending on **clean energy**, including working towards establishing an investment tax credit of up to 30% for support toward businesses focusing on net zero technology, battery storage solutions and clean hydrogen. New commitments that encourage the use of zero emission vehicles and introduction of charging stations were also announced, as well as plans for a **Canada Growth Fund** that will aim to attract investment in new technology and restructuring supply chains for natural resources.
- The budget aims to provide additional **support for small businesses**, phasing out access to the small business tax credit more gradually, with an end point of $50 million in taxable capital rather than the previous $15 million.
- A focus on critical mineral mining projects, with support in the form of infrastructure investments, supply chains, and introduction of a new 30% tax credit for specific mineral exploration expenses. The proposal also includes funds designed to attract new investment in the EV, battery and critical minerals space.

Revenue generation:

The budget introduced several key pieces of new revenue. Most notable is further detail on a planned **increase in the corporate tax rate for banks and life insurance companies**, from 15% to 16.5%. As part of this, a one-time **"Canada Recovery Dividend"** of 15% will also be levied on banks and insurance companies on taxable earnings greater than $1 billion for the 2021 tax year.

Other proposed tax measures include:

- Amendments to the Income Tax Act to prevent the use of foreign shell companies and offshore investments in avoiding paying tax and investment income. This includes amending the Income Tax Act to prevent deductions incurred as a result of taking both sides of a position in a stock, and eliminating the tax avoidance benefits of using interest coupon stripping for cross-border interest payments.
- Examining a new minimum tax regime on the wealthiest Canadians, the details of which will be released in the 2022 fall economic and fiscal update.
- Examination of previously announced spending plans to in light of a stronger-than-anticipated economic recovery in order to find $6 billion in future savings.

Economic implications

The proposed new spending will cost an additional $31 billion over five years, which amounts to 1-2% of GDP. This is a substantially smaller increase than the previous pandemic-era budgets, though unlike during the pandemic there is no sudden need for new fiscal support. While many of the measures have considerable individual merits, any additional government spending risks raising inflation even higher and overheating the economy in a fashion that necessitates additional monetary tightening – raising the risk of a later recession.

Fiscal considerations

The budget now projects that the deficit will shrink to $114 billion in 2022, down $31 billion from initial estimates due primarily to faster-than-expected economic growth and increased revenues. The budget then projects that the deficit will shrink to $53 billion in 2023, and to $40 billion in 2024, stopping short of a balanced budget with an $8.4 billion deficit projected all the way out in 2027.

The federal debt is projected to shrink, moving from 46.5% of GDP today to 41.5% of GDP in 2026-2027. This is a faster decline than previously forecast, thanks in large part to higher nominal revenues resulting from high inflation and elevated commodity prices, and despite the prospect of higher borrowing costs. It's fair to ask whether these longer-term forecasts are entirely realistic given that they presume no recession ever arrives, whereas in reality these come along every five or ten years and are extremely costly – as demonstrated by the pandemic and the global financial crisis before it.

Despite the Liberal government's minority status, this budget should easily pass given the party's confidence agreement with the NDP.

Time to lock-in historic low rates

Lock-in prescribed rate loans at 1% and potentially save on overall family taxes.

You may be able to reduce your overall family taxes by splitting income with lower-income family members. One way to split income is by making loans to your lower-income family members for investment purposes and charging the Canada Revenue Agency (CRA) prescribed interest rate on the loan.

Currently, the CRA prescribed interest rate is at a historic low of 1% but given recent interest rate hikes, it may be increasing to 2% for the quarter beginning July 1st, 2022. This means that it will become less advantageous to implement this income splitting strategy. As the interest rate on a prescribed rate loan is locked-in for the life of the loan regardless of any future interest rate increases, now is the time to

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consider setting up a new loan, or add to your existing loan, at 1%!

The CRA prescribed interest rate

The CRA has a number of prescribed rates that apply in different situations. This article focuses on the lowest prescribed interest rate which is used to calculate the taxable benefit on interest-free or low-interest employee or shareholder loans. This rate also applies to loans between family members who want to split income.

The prescribed rate is calculated quarterly and is based on the average 90-day T-bill rate for the first month of the previous quarter. The average is rounded to the next higher whole number. For example, if the average of the 90-day T-bill rate for April 2022 is 1.35%, the CRA will round up the prescribed rate to the next higher whole number (i.e., 2%) for the next quarter, Q3 2022.

Income splitting basics

Income tax is based on a progressive tax system where, as your taxable income increases, so does your marginal tax rate on an individual basis. In some provinces, the top marginal tax bracket can be as high as 55%. This can result in families with one high-income earner and one low-income earner paying more tax than those with two family members who have equal incomes, even if the total household income is the same in both cases.

Income splitting is a tax planning strategy whereby you may be able to reduce your family's overall tax bill. It involves moving income from a family member in a high tax bracket to one in a lower tax bracket. However, there are attribution rules designed to prevent family income splitting in certain circumstances. If the attribution rules apply, the result is that the income earned by the lower-income family member is attributed back to the higher- income individual who provided the funds so there will be no tax savings.

There is an exception to the attribution rules where you loan money to family members and receive at least a minimum rate of interest prescribed by the CRA – this type of loan is called a prescribed rate loan. If properly implemented, it may allow you to avoid attribution and achieve your income splitting objectives.

Prescribed rate loan strategies

The prescribed rate loan strategy involves making a formal loan to family members, including your spouse, adult children, or minor children through a family trust, at the CRA prescribed interest rate. Your family members can then invest the loaned funds and earn investment income. The net income earned is taxed in their hands at their lower marginal tax rate.

To ensure that the income earned is not attributed back to you, the interest on the loan must be paid by January 30th of the following year (and by January 30th of every subsequent year that the loan is in place). It is crucial to meet the January 30th deadline, because if the interest payment is late by even one day, the attribution rules will apply for the year that the interest payment relates to, and all subsequent years, until the loan is repaid.

With the present low prescribed rate of 1%, you may be able to realize substantial tax savings by implementing a prescribed rate loan strategy prior to the expected increase in rates. This low rate allows you to effectively split income earned in excess of 1%. In order for the loan to be tax-efficient, the rate of return on investments should exceed the interest paid.

The advantage of setting up a loan when the prescribed rate is 1% is that this low rate is locked-in for the life of the loan, regardless of any future increases that may occur to the prescribed interest rate.

Below we have outlined two commonly used prescribed rate loan strategies that illustrate income-splitting in action.

The spousal loan strategy

With the spousal loan strategy, you make a loan to your lower-income spouse, who then invests the entire loan in their name. When properly structured, the investment income is taxed at your spouse's lower marginal rate, reducing your family's overall taxes. The interest income paid (on or before January 30 the following year) is taxable to you and your spouse may be able to deduct the interest paid on the prescribed rate loan.

The family trust strategy

With this strategy, a family trust is established for your lower-income family members, then funds are loaned to the trust at the CRA prescribed interest rate. The money loaned to the trust is then invested in the trust and the investment income (less 1% paid to you by January 30th of the following year) can be taxed in the hands of your spouse, children, or grandchildren. Each of these family members can earn approximately $10,000 of interest income, $20,000 of capital gains or between $18,000 and $54,000 of eligible dividends from Canadian public companies tax-free federally every year if they have no other income. The actual tax-free amounts may vary depending on their province of residence.

By loaning the money to the trust, you retain access to the capital loaned, and the investment income can be used to benefit your children and grandchildren, for example to pay for private school tuition, camp fees, lessons or gifts.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.

In response to the growing refugee crisis in Ukraine, *Grimes Handscomb Asset Management* has donated $5,000 to the United Nations High Commissioner for Refugees (UNHCR) Crisis appeal, which has been generously matched by RBC for a total donation of $10,000. The UNHCR is working with the United Nations, authorities, and other partners, to provide humanitarian assistance to the millions of people, mostly women and children, who have fled Ukraine as a result of the Russian invasion.

What's the secret to Aurelia's much-sought-after tomato sauce that arrives in the fall?

A well planned and strategic approach to her spring garden work! It's no easy task getting the garden ready but Aurelia relishes in the planning and design of her vegetable garden each year. Whether it's rearranging the location of certain vegetables, enriching the soil or designing elaborate pest deterrents (think tin foil and a hockey stick!), Aurelia is always building on the previous year's successes. We can't wait to taste the results!

Benchmarks

Equity market 12-month trailing return (for month ending March 31, 2022)	
S&P/TSX composite total return index	20.2%
S&P 500 total return (C$)	15.1%
S&P 500 total return (U$)	15.6%
DJIA total return (C$)	6.6%
DJIA total return (U$)	7.1%
Nasdaq composite price return (C$)	6.8%
Nasdaq composite price return (U$)	7.4%

RBC CM Canadian bond market indices 12 month trailing return (for month ending March 31, 2022)	
Short Term Index	-3.3%
Intermediate Term	-5.0%
3 month T-Bill (C$)	0.1%
3 month T-Bill (U$)	0.0%

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