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Federal budget briefing 2022

APR 7, 2022 42 MIN READ

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The Honourable Chrystia Freeland, Deputy Prime Minister and Minister of Finance, tabled the Liberal government's second budget during the COVID-19 pandemic.

Budget 2022 contains several targeted income tax changes affecting Canadian businesses and individual taxpayers. Budget 2022 proposes to introduce new rules addressing the dividend deduction available to financial institutions engaging in certain hedging transactions, borrowing by defined benefit pension plans, the applicable withholding tax rates for certain stripped interest coupons, CCPCs, and the impact of IFRS 17 on insurance contracts. New tax incentives targeting investments in carbon capture and storage and other clean air technologies are included. Budget 2022 also proposes two new taxes on banks and life insurers, provides an update on international tax reform measures, proposes to eliminate the flow-through share regime for oil, gas and coal activities, and introduces a new tax credit for individuals who invest in mining flow-through shares where the project targets specified minerals.

Budget 2022 contains various personal income tax measures, including a series of measures intended to make housing more available and more affordable. There are also several minor amendments impacting sales and excise taxes.

Our Budget Briefing 2022 summarizes some of the more relevant tax proposals included in this year's budget and presents a report from Osler Special Advisor Stephen Poloz, former Governor of the Bank of Canada.

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Report from Osler Special Advisor Stephen Poloz, former Governor of the Bank of Canada

Federal budget 2022: Moving on from COVID

The latest federal budget lays out a transition from COVID-fighting to a long-term plan focused mainly on promoting economic growth.

The fiscal response to the pandemic will someday be judged the most successful fiscal intervention in Canadian history — atypically, it was deployed extremely rapidly, and was calibrated elastically to the economy's needs. Fiscal policy was of course supported by aggressive monetary policy actions. But it was also supported by Canada's major banks, which stepped up with mortgage deferral programs, expanded credit availability for firms (the opposite of what happened during the Global Financial Crisis) and deployed the government's small business lending program. As a result the "Second Great Depression" was avoided, which needs to be kept in mind while evaluating the various details.

In short, the economy has vastly outperformed the expectations of both the government and private sector economists, and the fiscal situation is much stronger than most of the rhetoric suggests. Government programs are always announced in dollar terms, and these figures are interpreted literally by critics and the media as "dollars out the door", and usually judged excessive. However, all of the government's COVID programs were designed to be as large or as small as necessary, depending on how many people were displaced and for how long — an elastic concept that meant that the announced fiscal price tag always had to be interpreted not as "dollars out the door", but rather as an envelope — essentially, a guess as to how high the total demand for the program could go.

This all goes to the debt situation. In pre-pandemic days, Budget 2019 showed outstanding government debt at 31% of GDP, and even though the government was running small deficits each year, that ratio was in steady decline and expected to reach 28.6% by fiscal 2023–24. For reference, that same ratio was around 66% when Canada went into fiscal crisis in 1994. Considering the very strong fiscal situation in 2019, and the fact that the economy was operating with inflation on target at 2% and unemployment at a 40-year low, Canada was exceptionally well placed to manage the economic consequences of COVID. In other words, the resilience that the Canadian economy has demonstrated in the past two years is not really that surprising. The lesson is that it is worthwhile to rebuild that resilience for future events.

While the Bank of Canada anchors its policy on a 2% inflation target, the government has chosen this debt ratio as its "fiscal anchor." It represents the best summary measure of all the minutiae underneath, not just every year, but cumulatively through time. A stable or declining government debt ratio is the minimum criterion for fiscal sustainability; as long as a government can comfortably service its debt, it never really has to pay it back, in much the same way we think of debt in the capital structure of a major corporation. The rate of interest matters, of course, because cashflows matter, but provided that the rate of interest that the government must pay to service its debt is less than the headline growth in the economy (real economic growth plus inflation), then the debt ratio will decline steadily even if the government only services the debt and does not pay any of it back. This criterion is being met easily with today's low interest rates and the situation can be sustained even as rates rise to more normal levels. For comparison, public debt service costs were over 6% of GDP back in the early 1990s' debt crisis, whereas today they are just over 1% of GDP, and the outlook for higher interest rates would only take us to around 2% of GDP for debt service. Importantly, the government is actively lengthening its debt maturity to lock in low interest rates for longer to mitigate this risk, too.

Budget 2021, tabled a year ago, estimated that the government debt ratio would rise from 31% to more than 51% due to the fiscal spending related to COVID, and then decline slightly in future years. In other words, the expectation was that the government would need to

borrow approximately 20% of Canada's GDP to support people through the pandemic while introducing some other initiatives along the way. The government's fiscal update last fall, however, showed the effects of a much stronger than expected economy; the debt ratio was estimated to peak at 48% — some $60 billion less than previous forecasts of a peak debt ratio of 51% — and then to decline by around 1% per year thereafter.

Budget 2022 shows that the economy has grown even faster, and inflation has been far higher, than expected in last year's budget. Both fuel government tax revenues, and reduce government outlays. Accordingly, fiscal deficits have been lower, and debt has risen by less than planned; on top of which, the denominator of the debt ratio — total spending in the economy — is much higher than planned. The net effect is that the debt ratio now peaks at 46.5% in fiscal 2021–22 (the year just concluded), nearly 5 percentage points lower than originally laid out in Budget 2019. This is equivalent to a saving of over $100 billion compared to 2019 expectations. The debt ratio is now expected to fall by a further 5% over the next five years, to 41.5%.

The fiscal windfall in the latest budget plan is approximately $80 billion over five years, $36 billion of this in the year just ended. It is well known that the government has ambitious social plans, and the scope of these plans has widened considerably since the agreement to collaborate with the NDP. Accordingly, many observers were expecting this entire fiscal windfall — and possibly even more than that — to be spent in new programs in Budget 2022.

Instead, the government has attempted to strike a balance between using this flexibility to deploy new initiatives now and "banking" some of the windfall for the next rainy day. Obviously, running with a government debt ratio somewhere between 41% and 45% is better than one at 50% or higher, but it is still much higher than the 30% ratio from 2019 that equipped us so well to deal with COVID. The long-range forecasts in the budget show that the debt ratio will fall much faster than in last year's budget, but it will still take until the late 2030s to return to around 30%. Whether this return is seen as rapid enough to prepare us for future uncertainty is ultimately a political question, for it would require a higher taxation profile (or significant government spending cuts) to speed it up meaningfully. That is, unless the economic growth assumptions turn out to be too pessimistic once again.

Importantly, many years ago the government adopted the practice of basing its fiscal plan not on its own economic forecasts but on the forecasts of a group of private sector economists. This eliminated the old problem of those economists criticizing the budget for viewing the future through rose-coloured glasses. What this means is that any initiatives that the government takes that succeed in boosting long-term economic growth will generate fiscal outcomes that are better than those in the budget.

In this budget, the government has announced multiple new initiatives related to housing (roughly $2 billion per year), defence (approaching $2 billion per year), energy transition ($2–3 billion per year) and reconciliation initiatives (also close to $2 billion per year). There is over $50 billion in new commitments over the life of the budget, but also some increased revenues from higher taxes ("tax fairness") and "effective government" (taking a sharp pencil to government operations). Netting this all out, nearly half of the fiscal room that has been created has been dedicated to reducing the debt ratio to help prepare for future contingencies, while the rest has been allocated to new initiatives.

The fact remains that the government still shows fiscal deficits every year of their plan. With the economy clearly operating at full capacity, possibly in a state of excess demand, the projected deficit of $53 billion for the 2022–23 fiscal year will be seen by many as adding stimulus to an economy that is already too hot, thereby potentially adding to inflation pressures. A deficit of $53 billion implies stimulus to the economy of about 2% of GDP, and that stimulus only falls to 1.4% of GDP in fiscal 2023–24. This stimulus profile raises the risk

that interest rates in Canada will need to rise above neutral during 2023 to prevent a further acceleration in inflation.

An important mitigant to this inflation risk is the various measures the government is taking to boost the supply side of the Canadian economy and create a steeper long-term growth trend line. First among these, last year's childcare program — now signed by all provinces and territories — is virtually certain to bring more women into the workforce. This is the sort of social investment that can literally pay for itself, as each new entrant into the workforce generates new tax revenues. Second, the government has tweaked the temporary foreign worker program. This is particularly useful for the agricultural sector, but is more widely used than generally appreciated. It is used by tech companies to recruit engineers, and even by universities to recruit international PhDs. It is therefore a powerful immigration channel. A third supply initiative is overall immigration, which is really picking up speed, and will receive extra attention this year due to events in Ukraine. With close to one million vacant jobs in Canada, many immigrants will find it very easy to find work; this will directly reduce excess demand in the economy, and therefore inflation pressures, by raising supply.

And then there is productivity, which increases output per person. Surveys suggest that companies have very strong investment intentions, to build on the deployment of new technology during the pandemic. This is an excellent sign, for pervasive uncertainty has been holding investment spending and productivity back for the past several years. The budget should boost this further, especially in the green economy and energy transition. Further, the emergence of increased flexibility in work arrangements will also add to productivity. The government has a range of measures aimed at supporting innovation and skills development and expanding the supply of housing, which is essential to support immigration and growth in the economy's supply side. Therefore, there is every reason to expect a significant uptick in productivity growth in the next couple of years. Accordingly, it seems likely that the government's forecast debt ratio is a conservative one, and could easily dip below the 40% level over the next five years.

Besides these likely improvements to the supply side of the economy, the global economy may slow overall due to the conflict in Ukraine, which could spill over into Canada, thereby cooling some parts of our economy. Therefore, the net effect of all these moving parts on the inflation outlook will be an area for debate and judgment, probably too close to call. Measured inflation should decelerate through the rest of 2022, but a lot depends on the impact of the Ukraine situation on commodity prices, as well as the lingering supply chain issues in China. Underneath all that, the demand-supply imbalances should be coming more into line as the year unfolds. The Bank of Canada will offer its summary judgment in its update on April 13.

The long and short of it is that anything the government does to tilt the long-term trend in economic growth upward is worth taking a bit of risk, even if it is inflation risk. Those looking for a renewed shift to "big government" will be disappointed by Budget 2022 — trend total program expenses remain under 15% of GDP, whereas back in 2019 they were envisioned to remain around 14% of GDP, a small difference, and the budget makes a strong commitment to a detailed government expenditure review with targeted savings. Perhaps the budget document itself is a leading indicator of a leaner operation — it came in at 304 pages this year, which compares favourably to last year's 724 pages.

Business income tax measures

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Hedging and short selling by Canadian financial institutions

The *Income Tax Act* (Canada) (ITA) generally permits a Canadian corporation, in computing its taxable income, to claim a deduction (the dividend received deduction) for the amount of a taxable dividend received on a share (a Canadian share) that it holds in another Canadian corporation. This dividend received deduction is intended to limit the imposition of multiple levels of corporate taxation on earnings distributed from one corporation to another, subject to carefully prescribed exceptions. There is no general prohibition in the ITA against the availability of the dividend received deduction where a taxpayer enters into a transaction that limits its economic risk exposure to a Canadian share upon which a dividend is paid. However, where certain transactions are entered into with non-resident or tax-exempt counterparties, exceptions to the dividend received deduction may have this effect.

Budget 2022 identifies a concern held by the government that certain taxpayers within financial institution groups are engaging in transactions that limit the consolidated group's economic risk on Canadian shares where a dividend received deduction is claimed. In the example provided, a Canadian bank owns Canadian shares, and a registered securities dealer in the Canadian bank's corporate group borrows identical shares under a securities lending arrangement and sells the borrowed shares short, thereby eliminating economic exposure to separate transactions in Canadian shares on a consolidated group basis.

Proposed amendments intended to address such transactions would apply to dividends and related dividend compensation payments that are paid, or become payable, on or after Budget Day. Grandfathering is proposed where relevant hedging transactions or related securities lending arrangements were in place before Budget Day, in which case the amendment would apply to dividends and related dividend compensation payments that are paid after September 2022.

Canada Recovery Dividend and additional tax on banks and life insurers

Budget 2022 proposes two taxes aimed specifically at banks and life insurers:

- **Canada Recovery Dividend**: A one-time 15% tax on the taxable income of a bank or life insurer group, which group would include any other financial institution (as defined in Part VI of the ITA) related to a particular bank or life insurer, subject to a $1-billion taxable income exemption to be allocated by agreement amongst such group members. Although the tax would be imposed for the 2022 taxation year (payable over five years), it would be based on the taxable income for the 2021 taxation year. Draft implementing legislation was not released.
- **Additional 1.5% tax**: An ongoing tax of 1.5% of the taxable income of these same bank and life insurer groups, subject to a $100-million taxable income exemption that can be allocated by agreements amongst group members. Draft implementing legislation was not released.

Budget 2022 also proposes to examine methods of addressing the use by federally regulated financial institutions of corporate structures in foreign jurisdictions to engage in transactions viewed by the government as aggressive tax avoidance. Such methods may include changes to the financial transaction approval process.

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Borrowing by defined benefit pension plans

Under the ITA, a registered pension plan is subject to certain prescribed conditions described in the *Income Tax Regulations* that must be satisfied at all times to ensure that the pension plan's registration does not become revocable. One such condition is that the registered pension plan cannot borrow money for purposes of the plan except for two limited circumstances: (i) the borrowing is for a term of not more than 90 days, is not part of a series of loans or other transactions and repayments and none of the property held in connection with the plan is used as security for the borrowing (except in certain circumstances where borrowing is required to provide for the payment of benefits or the purchase of annuities to avoid a distressed sale of the plan's property) (the 90-day borrowing limit); and (ii) the borrowing is for the purpose of acquiring real property for the purpose of earning income from that property, the total borrowing does not exceed the cost of the real property and none of the property held in connection with the plan (other than the real property acquired) is used as security for the borrowing (the real property borrowing limit). Certain temporary relief to the 90-day borrowing limit has also been provided in response to the COVID-19 pandemic that permits borrowing in excess of 90 days if that borrowing is repaid by April 30, 2022.

Budget 2022 proposes to amend the borrowing restrictions applicable to registered defined benefit pension plans that are not individual pension plans (a DB plan) to remove the 90-day borrowing limit and implement a new restriction for borrowings not related to the acquisition of real property. In particular, a DB plan may borrow money for purposes other than acquiring real property provided that the aggregate of all such borrowings is equal to the lesser of (i) 20% of plan net assets, computed as the excess, if any, of the value of the DB plan's assets over the amount of its outstanding borrowings; and (ii) the amount, if any, by which 125% of the DB plan's actuarial liabilities exceeds plan net assets (the non-real property borrowing limit). A DB plan also continues to be subject to the real property borrowing limit.

For purposes of applying the non-real property borrowing limit to a particular borrowing, the value of the DB plan's assets and the amount of unpaid borrowings of the DB plan are both determined on the first day of the fiscal period of the DB plan in which the particular amount is borrowed and the actuarial liabilities of the DB plan are determined on the effective date of the DB plan's most recent actuarial report.

The proposed changes are intended to apply to amounts borrowed by a DB plan on or after Budget Day.

As noted, the new borrowing restrictions are applicable only to registered defined benefit pension plans that are not individual pension plans. A registered pension plan that is a defined contribution pension plan or an individual pension plan remains subject to the current borrowing restrictions in the *Income Tax Regulations* (i.e., the 90-day borrowing limit and the real property borrowing limit).

International tax reform

Budget 2022 reinforces the government's commitment to the OECD's two-pillar plan for international tax reform agreed to in October 2021. Pillar One contains a new taxing right for market jurisdictions (where customers are located) to obtain a share of residual profit of a multinational enterprise. Pillar Two contains rules designed to ensure a global minimum tax rate of 15% for large multinational enterprises. For our detailed review of the two-pillar plan released by the OECD in October 2021, please see Osler Update dated October 12, 2021.

Budget 2022 notes that the government continues to work with its OECD partners to establish the Pillar One framework and bring the new rules into effect. The government indicates that while it is prepared to separately move forward with legislation for a standalone digital services tax, it is hopeful that timely implementation of Pillar One rules will make such legislation unnecessary.

Budget 2022 proposes to implement Pillar Two into Canada's domestic tax rules, including a domestic minimum top-up tax. While draft legislation was not released, the government indicated that the primary charging rule and domestic minimum top-up tax would be effective in 2023, with the secondary charging rules not effective before 2024.

To assist with the implementation of Pillar Two into the ITA, Budget 2022 announces a public consultation designed to elicit feedback so that when draft legislation is released it will take account of any necessary adaptations of the OECD model rules to the Canadian legal and income tax context. The consultation questions contained in the budget materials are designed to elicit feedback from taxpayers concerning the scope, charging provisions, computation of GloBE income or loss, computation of adjusted covered taxes, computation of effective tax rate and top-up tax, corporate restructurings and holding structures, tax neutrality and distribution regimes, administration, transition rules and definitions. The government requests interested parties provide written representations by July 7, 2022.

Interest coupon stripping

Part XIII of the ITA generally imposes a 25% withholding tax on interest paid or credited by a Canadian resident to a non-arm's length non-resident. The 25% withholding tax rate may be reduced for interest paid to a resident in a country with which Canada has a tax treaty — typically, to either 10% or 15%. For interest paid to U.S. residents, the Canada-U.S. tax treaty generally reduces the withholding tax rate to nil.

Budget 2022 proposes to introduce amendments that would affect the way in which withholding tax rates apply to certain stripped interest coupons. A stripped interest coupon is an entitlement to a periodic interest payment on a bond that has been removed from the principal amount of the bond and offered for sale as a separate security.

In particular, Budget 2022 proposes to apply withholding tax to two variations of what is described as an "interest coupon stripping arrangement" that were not addressed by earlier amendments to the ITA introduced in 2011 in response to a court decision. This court decision is presumably *Lehigh Cement Limited v. The Queen*, 2010 FCA 124, in which the Federal Court of Appeal (FCA) found that the general anti-avoidance rule (GAAR) did not apply to a coupon stripping transaction.

The first variation generally involves a non-resident lender, not resident in the U.S., selling the interest coupons in respect of a loan made to a non-arm's length Canadian-resident borrower to another person who is resident in the U.S. This U.S.-resident interest coupon holder could be either arm's length or non-arm's length with the Canadian-resident borrower. To the extent that the interest paid by the Canadian-resident borrower to the U.S. interest coupon holder under this arrangement is eligible for benefits under the Canada-U.S. tax treaty, the withholding tax rate to which it is subject would be reduced to nil. This variation could also involve a lender resident in a non-treaty country — or in a treaty country where the treaty provides for a relatively high rate of withholding tax on interest — selling interest coupons to a purchaser in any country with a lower treaty rate.

The second variation involves a non-resident lender, not resident in the U.S., selling the interest coupons in respect of a loan made to a non-arm's length Canadian-resident

borrower to a person resident in Canada. Under this variation, interest paid by the Canadian-resident borrower to the Canadian-resident interest coupon holder is not subject to withholding tax since it is not paid to a non-resident.

Budget 2022 proposes an amendment to the interest withholding tax rules that would cause the total amount of withholding tax paid under an "interest coupon stripping arrangement" to be the same as if the arrangement had not been undertaken and instead the interest had been paid to the non-resident lender.

In general terms, an "interest coupon stripping arrangement" would be considered to exist where the following conditions are met:

- a Canadian-resident borrower pays or credits a particular amount to a person or partnership (interest coupon holder) as interest on a debt (other than a publicly offered debt obligation) owed to a non-resident person with whom the Canadian-resident borrower is not dealing at arm's length (non-resident lender)
- the tax that would be payable under Part XIII in respect of the particular amount, if the particular amount were paid or credited to the non-resident lender, is greater than the tax payable under Part XIII on the particular amount paid or credited to the interest coupon holder

Where an "interest coupon stripping arrangement" exists, the Canadian-resident borrower would be deemed, for purposes of interest withholding tax, to pay an amount of interest to the non-resident lender such that the Part XIII tax on the deemed interest payment equals the Part XIII tax otherwise avoided as a result of the "interest coupon stripping arrangement."

This measure would apply to interest paid or payable by a Canadian-resident borrower to an interest coupon holder to the extent that such interest accrued on or after Budget Day, unless the interest payment meets the following conditions:

- it is in respect of a debt or other obligation incurred by the Canadian-resident borrower before Budget Day
- it is made to an interest coupon holder that deals at arm's length with the non-resident lender and that acquired the interest coupon as a consequence of an agreement or other arrangement entered into by the interest coupon holder, and evidenced in writing, before Budget Day

For cases falling within the above exception, the measure would apply to interest paid or payable by a Canadian-resident borrower to an interest coupon holder to the extent that such interest accrued on or after the day that is one year after Budget Day.

Exchange of tax information on digital economy platform sellers

In order to enhance tax compliance, Budget 2022 proposes to implement model rules developed by the OECD for reporting by certain digital platform operators. The rules are generally intended to apply to platforms that facilitate peer-to-peer activities, that connect clients or customers online or that provide a platform for sellers of goods.

While the onus is on sellers using such platforms to report their income in their tax returns, the CRA is concerned that such sellers may not be aware of their tax obligations or that such transactions may not be easily detected to determine compliance.

As a result, the proposed rules would require “reporting platform operators” to complete due diligence procedures to identify reportable sellers and their jurisdiction of residence and report to the CRA specified information concerning the seller. The measure would apply to Canadian-resident operators as well as to platform operators that are not resident in Canada (or a partner jurisdiction that has similar reporting rules) that facilitate relevant activities (such as personal services or rental of means of transportation) by sellers in Canada or with respect to the rental of immovable property in Canada.

There are a number of exemptions to the rules. The rules would not apply to pure payment processors, classified ads boards or online aggregators. In addition, operators would not have to report information to the CRA concerning governmental entities, publicly traded entities, large providers of hotel accommodation or those selling goods with fewer than 30 sales a year for a total of less than €2,000.

Under exchange of information provisions in tax treaties (and other similar instruments), the CRA would automatically exchange the information with other jurisdictions concerning sellers in those other jurisdictions and rental property located in other jurisdictions. The CRA would expect to receive information from other jurisdictions concerning Canadian sellers and rental property located in Canada.

The first reporting and exchange of information would take place in early 2025 with respect to the 2024 calendar year.

Investment tax credit for carbon capture, utilization and storage

Budget 2022 unveiled a new refundable investment tax credit for carbon capture, utilization and storage (CCUS) available for certain eligible expenses starting on January 1, 2022 (the CCUS tax credit).

Varying rates for the CCUS tax credit will apply depending on the use of the equipment and when the expenditure is incurred, as demonstrated in the following table:

	Incurred after 2021 through 2030	Incurred after 2030 through 2040
Eligible capture equipment used in a direct air capture project	60%	30%
All other eligible capture equipment	50%	25%
Eligible transportation, storage and use equipment	37.5%	18.75%

Eligible projects, equipment and uses

The CCUS tax credit is available in respect of the cost of purchasing and installing certain “eligible equipment” for an “eligible project” which uses the captured CO_2 for an “eligible use.”

An “eligible project” is a new project that

- captures CO_2 directly from ambient air or that would otherwise be released into the atmosphere;
- prepares captured CO_2 for compression;
- compresses and transports CO_2; or
- stores or uses captured CO_2.

Eligible equipment must be used solely for the capture, transport, storage or use of CO_2. In addition, such equipment must be part of an eligible CCUS project and put in use in Canada. Although the CO_2 must be captured in Canada, it may be stored or used outside Canada.

An "eligible use" for the purposes of the CCUS tax credit would include, initially, dedicated geological storage and storage in concrete. Jurisdictions with sufficient regulations to permit dedicated geological storage to ensure the permanent storage of CO_2 currently include only Alberta and Saskatchewan. For storage in concrete, the CCUS tax credit is available in all jurisdictions provided the appropriate process for storing CO_2 is approved by Environment and Climate Change Canada and at least 60% of the CO_2 that is injected into the concrete is mineralized and locked into the concrete produced.

Claiming the credit

Notably, the CCUS tax credit can be claimed on eligible expenses in the year in which the expense is incurred, regardless of when that equipment becomes available for use.

The CCUS tax credit is not available for equipment in circumstances where a previous owner has already received the CCUS tax credit.

Budget 2022 introduces two new capital cost allowance (CCA) classes, which are also eligible for enhanced first-year depreciation under the Accelerated Investment Incentive:

- an 8% CCA rate on a declining-balance basis for equipment that solely captures CO_2, transports CO_2, or CO_2 injection or storage equipment
- a 20% CCA rate on a declining-balance basis for equipment required for using CO_2 in an eligible use

These new CCA classes include the cost of converting existing equipment for use in a CCUS project, equipment for monitoring and tracking CO_2, and buildings or other structures solely supporting a CCUS project.

Although the exploration and development expenses relating to CO_2 storage would not be eligible for the CCUS tax credit, Budget 2022 proposes to introduce an additional two new CCA classes for intangible exploration and development expenses associated with CO_2 storage, which are depreciable at rates of 100% and 30%, respectively, on a declining-balance basis.

Taxpayers must track the amount of CO_2 being captured and monitor the portions of CO_2 for eligible and ineligible uses. The amount of the CCUS tax credit available in respect of a project that stores CO_2 through eligible and non-eligible uses is limited to the portion of CO_2

used in an "eligible use." Projects will be assessed at five-year intervals over a period of up to 20 years. The CCUS tax credit may be clawed back where the portion of the CO_2 going to an ineligible use exceeds 5% of the initial project plans.

Validation and verification

A validation and verification process is required for all projects that expect to have eligible expenses of $100 million or greater over the life of the project and may be opted into by taxpayers below the threshold. The process identifies expenses eligible for the CCUS tax credit and the tax credit rate expected to apply based on initial project designs. Prior to claiming CCUS tax credit amounts, eligible expenses must be verified by Natural Resources Canada. Budget 2022 states that verification is expected to occur as soon as possible after the end of the taxpayer's tax year prior to filing its tax return such that the refund can be processed upon filing.

Knowledge sharing and climate risk disclosure

Taxpayers seeking to claim the CCUS tax credit must also produce a climate-related financial disclosure report detailing management of climate-related risks and opportunities and their contribution to achieving Canada's goal of net-zero by 2050 and its commitments under the Paris Agreement.

Finally, CCUS projects with anticipated eligible expenses of at least $250 million are required to contribute to public knowledge-sharing in Canada in order to be eligible for the CCUS tax credit.

Further details on the validation and verification process, knowledge-sharing requirement, climate risk disclosure and recovery of the CCUS tax credit are expected to be released at a future date.

Budget 2022 also contemplates that the provinces may choose to enact credit programs similar to the CCUS tax credit; to date, no provinces have announced such programs.

Flow-through shares for oil, gas and coal activities

Budget 2022 proposes to eliminate the flow-through share regime for oil, gas and coal activities. Flow-through share agreements entered into by March 31, 2023 will be grandfathered.

Critical mineral exploration tax credit

Budget 2022 proposes to introduce a new 30% critical mineral exploration tax credit (CMETC) for individuals who invest in mining flow-through shares where the project targets specified minerals. The CMETC generally follows the current rules in place for the 15% mineral exploration tax credit (METC), but applies only in respect of projects targeting copper, nickel, lithium, cobalt, graphite, rare earth elements, scandium, titanium, gallium, vanadium, tellurium, magnesium, zinc, platinum group metals and uranium. Eligible expenditures are not permitted to benefit from both the METC and proposed CMETC.

The CMETC would be available in respect of expenditures renounced to investors under flow-through share agreements entered into after Budget Day and on or before March 31, 2027.

Tax credit for investments in clean technology

Budget 2022 proposes to introduce an investment tax credit of up to 30% for investments in net-zero technologies, battery storage solutions and clean hydrogen. Further details will be announced in the Fall 2022 Economic and Fiscal Update.

Sustainable agriculture

Budget 2022 announced Canada's investment in sustainable agriculture, with efforts to support agribusiness while reducing greenhouse gas emissions in the sector. Budget 2022 includes approximately $1.05 billion in funding for sustainable agriculture, including

- $329.4 million over six years to expand the Agricultural Clean Technology Program
- $469.5 million over six years towards expanding the On-Farm Climate Action Fund under the Agricultural Climate Solution initiative
- $150 million towards a new resilient agricultural landscape program aimed at supporting environmental co-benefits including carbon sequestration and adaptation
- $100 million over six years towards supporting post-secondary research relating to the development of crop varieties that allow for net-zero emission agriculture

Application of the general anti-avoidance rule to tax attributes

Budget 2022 proposes to amend the general anti-avoidance rule (GAAR) in response to a 2018 decision by the Federal Court of Appeal (FCA). *1245989 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114 (also referred to as *Wild v. Canada (Attorney General)*), concerned a taxpayer who entered into a series of transactions to increase the paid-up capital (PUC) of certain preferred shares but who had not yet received any tax-free distribution of retained earnings as a result of that PUC. The FCA concluded that because the PUC had not been used to effect a tax-free distribution, there was no "tax benefit" within the meaning of the GAAR and therefore no misuse or abuse of the relevant provision.

In response to *Wild*, Budget 2022 proposes to amend the GAAR and related provisions so that the GAAR can apply to transactions that impact the amount of a tax attribute relevant to the future computation of tax (such as PUC and adjusted cost base), even if the tax attribute has not yet been utilized.

The proposed draft legislation amends the definition of "tax benefit" to include "a reduction, increase or preservation of an amount that could at a subsequent time" be relevant to and result in the decrease of the amount of tax or other amount payable or the increase of the amount of a tax refund or other amount. The definition of "tax consequences" is similarly amended to include "any other amount that is, or could at a subsequent time be, relevant for the purpose of" reducing the tax or other amount payable or increasing a tax refund or other amount. Subsection 152(1.11) is also amended to allow notices of determination issued under that provision to reflect adjustments made under the GAAR to tax attributes.

The proposed amendment would apply to transactions that occur on or after Budget Day, and to any notices of determination issued on or after Budget Day (even if the adjustments reflected such notices concern transactions that occurred before Budget Day).

Genuine intergenerational share transfers

On July 19, 2021, Minister Freeland, while affirming that Bill C-208, which introduced changes to the law to facilitate intergenerational share transfers had become a part of the ITA, announced that the government intended to bring forward amendments to these newly introduced changes.

The concerns of the government seem to relate to “surplus stripping” where dividends would be converted to capital gains without a genuine transfer of the business actually taking place. The government had announced that amendments would address

- the requirement to transfer legal and factual control of the corporation carrying on the business from the parent to their child or grandchild
- the level of ownership in the corporation carrying on the business that the parent can maintain for a reasonable time after the transfer
- the requirements and timeline for the parent to transition their involvement in the business to the next generation
- the level of involvement of the child or grandchild in the business after the transfer

Budget 2022 announces a public consultation process on how the recently introduced exception to the rule preventing taxpayers from converting dividends into lower-taxed capital gains using certain self-dealing transactions could be modified to ensure that the recently introduced changes are not used for artificial tax planning purposes.

Comments can be submitted to the Department of Finance by June 17, 2022. Legislation addressing the government’s concerns related to “surplus stripping” will be tabled in the fall after the consultation process.

Substantive CCPCs

Budget 2022 contains measures aimed at the perceived avoidance of the anti-deferral rule applicable to Canadian-controlled private corporations (CCPCs) earning investment income. The government is targeting arrangements whereby a corporation loses its CCPC status by either becoming controlled by public and listed corporations or by non-residents of Canada, or by ceasing to qualify as a “Canadian corporation”, but where factual control is seen as remaining in the hands of Canadian-resident individuals. In those situations, the government considers it inappropriate that investment income (capital gains, interest, royalties, etc.) earned by the corporation is not subject to the additional refundable tax applicable to CCPCs and is taxed at the lower tax rate applicable to non-CCPCs. To address this concern, Budget 2022 proposes to create a new category of corporation that, while not technically a CCPC, will be taxed as if it were a CCPC on the basis that the corporation is a “substantive CCPC.” A substantive CCPC would be subject to the same additional refundable taxes that apply to a CCPC that earns investment income.

Under this proposed measure, a “substantive CCPC” is defined as a particular private corporation resident in Canada (other than a CCPC) that

- is controlled (in law or in fact), directly or indirectly, by one or more Canadian-resident individuals; or

- would be controlled (in law) by a particular individual if that individual owned all the shares of the particular corporation (or of any other corporations) that are owned by Canadian-resident individuals.

A corporation will 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 its shares, or but for the fact that it ceased to be a "Canadian corporation" (for example, by continuing under foreign corporate law while maintaining Canadian residency by keeping central management and control in Canada).

In addition, under a proposed anti-avoidance rule, a non-CPPC that falls outside the "substantive CCPC" definition will be deemed to be a substantive CCPC where it is reasonable to consider that one of the purposes of a transaction, or series of transactions, was to avoid substantive CCPC status.

Budget 2022 also proposes to facilitate administration of the rules applicable to investment income earned and distributed by substantive CCPCs, including a one-year extension of the normal reassessment period in certain circumstances.

This measure would generally apply to taxation years that end on or after Budget Day. However, for certain arm's length share sale transactions agreed to before Budget Day, it would apply only to taxation years that begin on or after Budget Day provided that such transaction is completed prior to 2023.

Deferring tax using foreign-resident corporations

Budget 2022 proposes to amend certain aspects of the foreign accrual property income (FAPI) regime as it applies to CCPCs and substantive CCPCs. Based on the current "relevant tax factor," where a Canadian corporate taxpayer has a controlled foreign affiliate (CFA) that pays foreign tax at a rate of 25% or greater, the taxpayer benefits from a deduction in respect of such foreign tax that fully offsets the taxpayer's corresponding FAPI inclusion. In contrast, individual taxpayers must pay foreign tax at a rate of 52.63% or greater to fully offset the individual's FAPI inclusion.

The availability of the full deduction for corporate taxpayers that pay foreign tax at a rate of 25% or greater allows CCPCs and their individual shareholders to defer taxes on passive investment income earned through CFAs because such passive investment income would have been taxed at a higher rate if it were earned in Canada. Certain amounts in respect of FAPI are also included in the general rate income pool (GRIP) of CCPCs. The GRIP inclusions entitle CCPCs to distribute FAPI as eligible dividends, which are subject to a lower tax rate.

Budget 2022 proposes to eliminate the tax-deferral advantage available to CCPCs and their shareholders earning investment income through CFAs by applying the same relevant tax factor to individuals, CCPCs and substantive CCPCs. As a result, if a CFA is subject to foreign tax at a rate lower than 52.63%, the corresponding FAPI inclusion will not be fully offset. Related amendments would address the integration of FAPI once repatriated to and distributed by CCPCs and substantive CCPCs to individual shareholders by

- removing certain deductions from the GRIP of a CCPC made in respect of (1) repatriations of a foreign affiliate's hybrid surplus and taxable surplus; and (2) the payment of withholding tax on inter-corporate dividends paid out of taxable surplus
- including in the capital dividend account of a CCPC on repatriation (1) the amount of an

inter-corporate dividend deduction claimed with respect to a dividend paid out of hybrid surplus less the amount of withholding tax paid with respect to the dividend; (2) the amount of an inter-corporate dividend deduction claimed with respect to a dividend paid out of taxable surplus; and (3) the amount of a withholding tax deduction claimed less the withholding tax paid in respect of repatriations of taxable surplus.

The proposed measures would apply to taxation years that begin on or after Budget Day. Budget 2022 does not include draft legislation setting out the proposed amendments.

IFRS 17: Insurance Contracts

International Financial Reporting Standards (IFRS) 17 sets out new accounting standards for insurance contracts that will substantially change financial reporting for all Canadian insurers. It will be effective as of January 1, 2023. In anticipation of the application of IFRS 17, Budget 2022 proposes generally to support the use of IFRS 17 as a means of computing income for tax purposes, with certain exceptions. The stated objective of these exceptions is "to recognize income for tax purposes when the key economic activities occur." The exceptions are set out according to the type of insurance contract, and will be applicable as of January 1, 2023:

- Life insurance contracts:
  - Only 10% of the contractual service margin (CSM) — a new reserve under IFRS 17 that defers the recognition of profits over the estimated life of the contract — will be deductible (but will be included in income as non-attributable expenses are subsequently incurred)
    - Special case: the CSM for segregated funds will be fully deductible in recognition that the income-earning activities relating to such funds are primarily investment management activities performed after the contract is entered into
  - Certain transitional rules are also proposed addressing the transition from IFRS 4 to IFRS 17 and the introduction of IFRS 9 on January 1, 2023
  - The non-deductible portion of the CSM, as well as deferred tax assets and accumulated other comprehensive income, will be included in the tax base for purposes of Part VI of the ITA
- Mortgage and title insurance:
  - 10% of the CSM is deductible (and included in income as non-attributable expenses are subsequently incurred)
  - 5-year transition period
- Property and casualty insurance:
  - Maintain current treatment given insignificance of the CSM reserve for short-term contracts
  - 5-year transition period

There are several aspects of the CSM proposal and the Part VI proposal that may be hotly debated and disputed by the insurance industry. Two aspects underpinning the proposal, in particular, are worth noting:

- Contrary to the position taken in the budget materials and in the May 2021 Release, the CSM defers recognition of "unearned" profits and recognizes profits when services are provided over the longer term of the insurance contract (that is, if and when the profits are earned).
- Taxing 90% of the CSM immediately upon the issuance of a long-term contract is simply remarkable. The budget materials implausibly suggest that the deferral of unearned profits is "undue" and that 90% of the insurer's "key economic activities" under a long-term insurance contract (often with a term in excess of 20 years) occur upon contract issuance.

Small business deduction

CCPCs currently pay a reduced corporate income tax rate of 9% (compared to the general rate of 15%) on up to $500,000 of qualifying active business income earned by associated CCPCs (the business limit). The business limit is reduced on a straight-line basis for CCPCs that, along with any associated corporations, have $10–$15 million of taxable capital employed in Canada, or that have $50,000–$150,000 of "adjusted aggregate investment income" — whichever results in a lower business limit.

Budget 2022 proposes to modify the business limit reduction that is based on taxable capital employed in Canada. The upper limit of the range is increased from $15 million to $50 million, meaning CCPCs can now have over three times as much taxable capital employed in Canada before they lose all benefit of the reduced 9% rate.

The modified range would apply to taxation years that begin on or after Budget Day. It is estimated to result in an estimated $660 million in tax savings over the 2022–2023 to 2026–2027 period.

Review of tax support to R&D and intellectual property

Budget 2022 announces the government intends to undertake a review of the existing Scientific Research and Experimental Development (SR&ED) program in the ITA to ensure that it is effective in encouraging research and development in Canada, as well as to explore opportunities to modernize and simplify it. Among other things, the review would examine whether changes are required to the eligibility criteria of the program. The government will also consider whether tax incentives can play a role in encouraging the development and retention of intellectual property stemming from Canadian research and development, including implementing a so-called "patent box" regime that would typically tax income earned from intellectual property at more favourable rates. No timeline is given for undertaking this review.

Employee ownership trust

Budget 2022 proposes to introduce to the ITA the concept of an employee ownership trust, a new dedicated type of trust to support employee ownership of a business. This initiative is further to consultations announced in Budget 2021, which consultations will continue to finalize the development of applicable rules. No date is provided for their introduction.

Personal income tax measures

Budget 2022 proposes various personal income tax measures. They include a series of measures intended to make housing more available and more affordable. These housing tax measures include the following:

- Creating, effective in 2023, the Tax-Free First Home Savings Account that would permit up to $40,000 of tax-deductible contributions, and the tax-free withdrawal of funds (including of earned investment income) to make qualifying first home purchases.
- Doubling the amount of eligible expenses for each of the existing First-Time Home Buyers' Tax Credit and Home Accessibility Tax Credit, effective January 1, 2022.
- Introducing, effective January 1, 2023, the Multigenerational Home Renovation Tax Credit, a refundable 15% tax credit on up to $50,000 of eligible costs to construct a secondary dwelling suite for an eligible relation (a senior or person with disability).
- Introducing a rule that would deny the 50% capital gains inclusion rate or the principal residence exemption to gains realized on the short-term sales of residential real estate (resulting in the gains being fully taxed as business income). The rule would apply effective January 1, 2023 on sales of property held less than 12 months, subject to exemptions for sales made due to certain life circumstances.
- Reviewing residential housing as an asset to understand the role of large corporate players in the housing market, and any adverse impact on Canadian housing costs. This review will include examining potential changes to the tax treatment of large corporate players that invest in residential real estate. Further details of the review will be announced later in 2022, potentially with early actions also announced in the year.

Other measures include proposed changes to the registered charities regime to increase the annual disbursement quota requirements applicable to large charities effective January 1, 2023. Other proposed changes would expand the operation of those rules that permit a registered charity to make qualified disbursements to certain non-qualified donees, provided the charity meets prescribed accountability requirements. Such other changes would be effective on the coming-into-force of the applicable legislation.

Finally, Budget 2022 proposes to examine a new minimum tax regime applicable to wealthy Canadians that would update the existing Alternative Minimum Tax. The government plans to release details on their proposed approach to this new regime in the 2022 Fall Economic and Fiscal Update.

Sales and excise tax measures

Budget 2022 includes several minor changes to sales and excise taxes.

For the GST/HST, Budget 2022 expands the availability of the GST/HST health care rebate and proposes to make all assignment sales of newly constructed or substantially renovated residential housing taxable.

Budget 2022 proposes certain refinements to the taxation of vaping products, following a public consultation after Budget 2021. Specifically, it provides that duty would apply at a rate of $1 per 2ml for the first 10ml of vaping substance and $1 per 10ml for volumes beyond that. Budget 2022 also states that the federal government will “work collaboratively” with provinces and territories interested in participating in a co-ordinated vaping taxation regime administered by the federal government, in which case additional duty would apply at the same rate as the federal duty.

Budget 2022 also proposes certain amendments to the *Excise Act, 2001*. Specifically, it is proposed to make certain amendments to the Cannabis Framework and certain administrative changes, such as changing the types of financial security that can be accepted by the CRA and confirming the ability of the CRA to conduct certain audit activities virtually.

Other measures

Increased funds to the Canada Revenue Agency

Budget 2022 proposes to spend an additional $1.2 billion over five years, starting in 2022–2023, to expand audits of larger entities and non-residents engaged in aggressive tax planning, to increase both the investigation and prosecution of those engaged in criminal tax evasion and to expand its educational outreach (with forecasted federal revenues of $3.4 million over five years from such efforts, plus additional benefits to provinces and territories).

Budget 2022 notes that this spending builds on the previous $2.2 billion in resources provided to the CRA since Budget 2016, which has yielded a return of five dollars to each dollar invested until 2020–2021.

Outstanding tax measures

Budget 2022, in accordance with the government’s customary disclosure of previously announced measures, confirms the government’s intention to proceed with previously announced tax and related measures, as modified to take into account consultations and deliberations since their release, including the following:

- legislative proposals relating to the *Select Luxury Items Tax Act* released on March 11, 2022
- legislative proposals released on February 4, 2022 in respect of the following measures:
    - electronic filing and certification of tax and information returns
    - immediate expensing
    - the Disability Tax Credit
    - a technical fix related to the GST Credit top-up
    - the rate reduction for zero-emission technology manufacturers
    - film or video production tax credits
    - postdoctoral fellowship income
    - fixing contribution errors in registered pension plans

- a technical fix related to the revocation tax applicable to charities
- capital cost allowance for clean energy equipment
- enhanced reporting requirements for certain trusts
- allocation to redeemers methodology for mutual fund trusts
- mandatory disclosure rules
- avoidance of tax debts
- taxes applicable to registered investments
- audit authorities
- interest deductibility limits
- crypto asset mining

- legislative proposals tabled in a Notice of Ways and Means Motion on December 14, 2021 to introduce the *Digital Services Tax Act*
- legislative proposals released on December 3, 2021 with respect to Climate Action Incentive payments
- the income tax measure announced in Budget 2021 with respect to Hybrid Mismatch Arrangements
- the transfer pricing consultation announced in Budget 2021
- the anti-avoidance rules consultation announced on November 30, 2020 in the Fall Economic Statement
- the income tax measure announced on December 20, 2019 to extend the maturation period of amateur athletes trusts maturing in 2019 by one year, from eight years to nine years
- measures confirmed in Budget 2016 relating to the Goods and Services Tax/Harmonized Sales Tax joint venture election

If you have any questions or require additional analysis on Budget 2022, please contact any member of our National Tax Department. We invite you to register for our seminar on Tuesday, April 26 for further analysis of Budget 2022 and draft legislation previously released on February 4, 2022.

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