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Canadian Tax and Legal alert

2022-2023 federal budget highlights

April 8, 2022

Deputy Prime Minister and Minister of Finance, the Honorable Chrystia Freeland, presented Budget 2022 entitled "A Plan to Grow Our Economy and Make Life More Affordable" in the House of Commons on April 7, 2022.

A summary of the proposed tax measures contained in the budget is provided below.

Deloitte professionals can help you understand how these measures may impact your business. If you have any questions, please reach out to your Deloitte advisor or any of the individuals noted in this alert.

C-suite briefing notes

What wasn't there

- Notwithstanding continued concern from many in the business community regarding the funding of budget deficits, there were no broad increases to personal or corporate tax rates, no increases in goods and services tax (GST) or harmonized sales tax (HST), and no new taxes on wealth, inheritance or capital. The capital gains inclusion rate remains at 50%.

- After two years of various COVID-19 measures, there were no modifications or extensions to existing government plans, such as the Canada Emergency Wage Subsidy (CEWS) or the Canada Emergency Rent Subsidy (CERS).

- While a number of tax measures were announced for consultation in Budget 2021, draft legislation has not yet been released. Furthermore, many tax measures announced in Budget 2022 were in the form of launching consultations rather than proposed legislation. Detailed rules on Canada's implementation of international tax agreements, known as Pillar One and Pillar Two, were also not released. Many items were explicitly deferred until the fall economic update.

New taxes for the banking and life insurance sector

Consistent with the Liberal Party's 2021 election platform, the government has introduced several new measures that are focused on raising revenue from larger entities in the banking and life insurance sector. All told, the following measures are expected to generate approximately $9 billion of revenue over the next 5 years.

- A permanent increase in the corporate tax rate of 1.5% (to a federal rate of 16.5%) for bank and life insurance groups for taxation years that end after April 7, 2022. A $100 million taxable income exemption on the 1.5% increase will be available for each group.

- A one-time tax, known as the Canada Recovery Dividend, equal to 15% of taxable income for bank and life insurance groups, on taxable income in excess of $1 billion. The tax is based on taxable income for taxation years ending in 2021 and will be payable over five years.

- Additional insurance-industry specific changes, including transitional rules to address new accounting standards for insurance companies (IFRS 17), subject to eliminating the deductibility of additional reserves.

- For groups containing a registered securities dealer, there are modifications to eliminate deductions for certain hedged transactions.

A green economy, continued innovation & ongoing reconciliation – incentives & changes

Building on the government's goal of net zero by 2050, significant funding through a variety of incentives were announced, including a new $15 billion Canada Growth Fund. Tax measures were significant, with certain investment tax credits at double the rate of what the Liberal Party had suggested in their 2021 election platform, along with a refundable component.

- Significant new tax credits to encourage businesses investment in carbon capture, utilization and storage (CCUS). Refundable investment tax credits are proposed to be up to 60% of the cost of equipment used in direct air capture, up to 50% of other eligible capture equipment, and 37.5% on eligible transportation, storage and use equipment for those incurred after 2021 and through 2030 and then dropping to half of the amount for expenses incurred through 2040.

Furthermore, companies making claims under the CCUS will be required to produce a new financial disclosure report highlighting how their work is contributing to Canada's goal of net zero by 2050.

- Modifications to sector specific flow-through shares, including an enhanced 30% critical mineral exploration tax credit for certain minerals, including nickel, lithium, graphite, copper or uranium (among others). As previously signaled, the government is proceeding with the elimination of flow through shares for oil, gas and coal.

The government also announced a review of the scientific research & experimental development (SR&ED) program to further simplify the program and ensure it is encouraging research and development (R&D) that benefits Canada. As part of this review, the government will consider a federal "patent box" regime, whereby the monetization of Canada's intellectual property could be subject to a reduced rate of taxation. The last broad review of federal support into R&D was concluded in 2011.

Importantly, the government continued its work towards reconciliation, with a total of $10.6 billion invested over 5 years. This work included a commitment to continue to negotiate tax agreements with interested Indigenous governments to facilitate the introduction of various forms of taxation, including possible income taxes, commodity taxes such as a First Nations GST or excise taxes on fuel, alcohol, cannabis and tobacco within certain areas. Such agreements would expand on the existing 61 tax jurisdiction agreements entered into since 1998.

A tax break for private businesses, along with anti-avoidance measures relating to investment income

A surprise tax break was announced for many mid-market Canadian private businesses. Canadian-controlled private corporations (CCPCs) benefit from a reduced rate of federal tax of 9% (vs 15%) on the first $500,000 of taxable income, which is subject to a full elimination where taxable capital exceeds $15 million. Going forward, the small business deduction will be eliminated when taxable capital exceeds $50 million, although the phase out will continue to start once taxable capital exceeds $10 million.

Continuing a multi-year trend of increasing Canada Revenue Agency (CRA) resources, additional funding of $1.2 billion over the next 5 years was announced. Specific focus areas included larger entities and non-residents engaged in aggressive tax planning. The increased funding aligns with further commitments on modernizations to the general anti-avoidance rule (GAAR) by the end of 2022, which were previously signaled.

In a specific tax measure expected to raise $4.2 billion over 5 years, proposals to prevent the partial deferral of taxation on investment income by private corporations were announced. These rules seek to ensure that integration – the concept that the taxation of investment income should be the same when realized personally or through a private corporation – remains intact. While detailed legislation is forthcoming, the measures may impact relatively common planning techniques used to enhance the tax attributes of an acquired entity. Furthermore, an enhanced minimum tax on high income earners was committed in the 2022 Fall Economic and Fiscal Update, to correct a concern that, in 2019, an estimated 28% of taxpayers with over $400,000 of gross income paid less than 15% federal tax.

Further details on tax measures

Private corporations and high net worth individuals

- Increased access to small business deduction by increasing the range of the taxable capital employed in Canada (TCEC) to be between $10 million and $50 million for the phase-out of the small business deduction. Previously, the small business deduction was phased out as TCEC increased from $10 million to $15 million or when 'adjusted aggregate investment income' increased between $50,000 and $150,000. The range of adjusted aggregate investment income remains unchanged. This measure will apply to taxation years that begin on or after April 7, 2022.

- **Introduction of the concept of "substantive CCPC" status to prevent certain entities from achieving non-CCPC status** and thereby obtaining a significant tax-deferral opportunity on passive income. While detailed legislation is forthcoming, the measures may impact relatively common planning techniques used to enhance the tax attributes of an acquired entity.

  A substantive CCPC would be a private corporation resident in Canada that is ultimately controlled (in law or in fact) by Canadian-resident individuals. This would include deeming a corporation to be a substantive CCPC based on the aggregation of shares owned, directly or indirectly, by Canadian resident individuals. In addition, it would also cause a corporation to be a substantive CCPC if it would have been a CCPC but for the fact that a public corporation or a non-resident has a right to acquire its shares.

  The Budget proposes to include targeted anti-avoidance measures to address scenarios where transactions are undertaken to avoid anti-deferral rules applicable to investment income.

  The measure would apply to taxation years that end on or after April 7, 2022; however, an exception is anticipated where the tax year of the 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, if the purchase and sale agreement was entered into before April 7, 2022 and the share sale occurs before the end of calendar 2022.

- **Alignment of the tax treatment of passive income earned by CCPCs and substantive CCPCs through controlled foreign affiliates with that of similar income earned within Canada** by decreasing the deduction available in respect of foreign taxes paid in respect of such income. This will be achieved by changing the 'relevant tax factor' as well as removing the addition to the 'general rate income pool' of a CCPC that can otherwise arise in respect of certain types of foreign accrual property income (FAPI). This measure will apply to taxation years that begin on or after April 7, 2022.

- **Increases to a private corporation's ability to pay tax-free dividends to Canadian-resident shareholders** to the extent of certain offshore earnings and capital gains that are subject to foreign taxes. This improvement to overall integration will be achieved by increasing a corporation's capital dividend account by the amount of any deductions claimed in respect of dividends paid out of a foreign affiliate's hybrid or taxable surplus balances. These changes will apply for taxation years that begin on or after April 7, 2022.

- **Increases to the registered charity disbursement quota from the current 3.5% to 5%** for the portion of property not used in charitable activities that exceeds $1 million, effective for charities' fiscal years that begin on or after January 1, 2023.

- **Changes to charitable partnerships** to allow charities to make qualified disbursements to organizations that are not qualified donees in furtherance of charitable purposes, subject to certain conditions. The main condition is that there must be a written agreement between the charity and grantee that requires any funds not used by the grantee for the purposes for which they were granted be returned to the charity. This would take effect on the legislation receiving Royal Assent.

Financial sector

- **Introduction of the Canada Recovery Dividend,** a 'one time' 15% tax on bank and life insurer groups. This tax would be applicable to taxable income in excess of $1 billion per group of companies, computed with reference to taxation years ending during 2021. The $1 billion exemption would be allocable amongst group members. Liability for this tax would arise in the 2022 taxation year and would be payable in equal amounts over five years.

- **Application of an additional tax on banks and life insurers of 1.5%** (not a 3% increase as proposed by the Liberals in the 2021 election) on members of bank and life insurer groups on taxable income of the group in excess of $100 million. Similar to the Canada recovery dividend, this $100 million exemption can be allocated across members of the group. This tax increase would be applicable to taxation years that end after April 7, 2022 but would be prorated for the number of days in a taxation year after April 7, 2022.

- **Proposed relieving measures to mitigate the impact of the government's May 2021 announcement to not allow insurance corporations to deduct for tax purposes certain reserves claimed** for accounting purposes under IFRS 17. The budget also includes measures designed to prevent the reduction of a life insurer's Part VI Tax on Capital of Financial Institutions that would otherwise occur because of changes in accounting rules due to IFRS 17.

- **Proposals to deny the dividend received deduction in certain situations involving hedging transactions where a registered securities dealer obtains a deduction.**
    - A taxpayer cannot deduct a dividend on Canadian shares if a registered securities dealer that does not deal at arm's length with the taxpayer hedges the taxpayer's economic exposure to the shares, provided the dealer knew or ought to have known the transactions would eliminate all or substantially all of the taxpayer's economic exposure.
    - Second, a registered securities dealer cannot deduct a dividend it receives on a Canadian share when it eliminates all or substantially all of its economic exposure by entering into certain hedging transactions.
    - In both cases under which the proposed rules deny the intercorporate dividend, the Budget changes may permit the registered securities dealer to deduct the entire compensation payment, rather than 2/3 of the payment.

    These proposed amendments will apply to dividends and dividend compensation payments that are paid, or become payable, on or after April 7, 2022, with grandfathering for hedging transactions in place before April 7, 2022, in which case the amendment applies to dividends and related dividend compensation paid after September 2022.

Resource sector and environmental measures

- **Introduction of a new refundable investment tax credit for expenditures representing the cost of installing and purchasing eligible equipment used in CCUS activities,** starting on January 1, 2022 and incurred through 2040. Validation and verification requirements, as well as certain financial disclosures, would need to be met to be eligible for the credit.

  The credits are potentially significant, computed at rates of 60% for eligible equipment used in direct air capture projects, 50% for other eligible capture equipment, and 37.5% for eligible transportation, storage and use equipment. These rates would be applicable for 2022 through 2030, with the rates being halved for eligible expenditures incurred from 2031 through 2040.

- **Introduction of various new classes of property for capital cost allowance (CCA) purposes, including:**
    - CCUS, as well as costs in respect of the conversion of equipment for such uses, equipment for monitoring CO2, and structures that support a CCUS project: depreciable on an 8% declining balance basis.
    - Equipment required for using captured CO2 for an eligible use, as well as similar costs to those outlined above in respect of conversion, monitoring, and supporting structures: depreciable on a 20% declining balance basis.
    - Intangible exploration expenses in relation to a CCUS project: depreciable on a 100% declining balance basis.
    - Development expenses in relation to a CCUS project: depreciable on a 30 per cent declining balance basis.

- **Elimination of flow-through share regime for oil, gas and coal** for expenditures renounced under agreements entered into after March 31, 2023. Notably, this measure applies to all flow-through shares, and not only those held by individuals.

- **Creation of critical mineral exploration tax credit** to provide a 30% credit of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors. Those specified minerals include copper, nickel, lithium, uranium, and others. This new credit would be applicable to eligible flow-through share agreements entered into after April 7, 2022 and on or before March 31, 2027.

- **Inclusion of air-source heat pumps primarily used for space or water heating under Classes 43.1 and 43.2**, effective for eligible property acquired and that become available for use on or after April 7, 2022. In addition, the manufacturing of air-source heat pumps is expected to qualify for the reduced corporate tax rates that apply to zero-emission technology manufacturing and processing which were announced in Budget 2021.

International measures

- **Proposal to neutralize non-resident withholding tax benefits realized by virtue of interest coupon stripping arrangements** in respect of interest that accrues on or after April 7, 2022, unless the holder of the coupon deals at arm's length with the non-resident creditor in respect of the debt, in which case, the proposed measures will apply to interest accruing on or after April 7, 2023. More specifically, the Canadian debtor will be deemed to pay such interest to the non-resident creditor in respect of the debt, rather than to the coupon holder.

- **Announcements that the government will continue working towards the implementation of certain measures to implement a global minimum tax** (including the income inclusion rule and a domestic minimum top up tax), anticipated to be implemented during, and effective for, 2023 as of a date to be determined. An undertaxed profits rule would be implemented no earlier than 2024.

- **Reiteration of the government's intention to implement measures intended to reallocate taxing rights in respect of the world's largest multinational organizations** once model rules and terms of a multilateral framework have been agreed to by members of the Organisation for Economic Co-operation and Development (OECD) / Group of 20 (G20) Inclusive Framework on Base Erosion and Profit Shifting. The government reiterated its support of a domestic Digital Services Tax in the event a new international system is not implemented.

- **Imposition of new information reporting requirements** for operators of certain digital platforms beginning in 2024. The rules would apply to entities that make software available to connect online sellers with other users, or that collect compensation for various activities facilitated through such platforms. The rules apply to operators who are resident in Canada, or, where operators are not resident in Canada or a jurisdiction that has implemented similar rules, to operators of platforms that facilitate activities relating to rental of Canadian real property or activities by Canadian-resident sellers.

Excise tax measures

- **Application of GST/HST on assignment sales by individuals** in respect of newly constructed or substantially renovated residential housing. Previously, a GST/HST exemption was allowed where the individual had originally entered into the agreement for any other primary purpose, other than for assignment sale. Thus, GST/HST would apply to the total amount paid for a new home by its first occupant. Also, a deposit amount, if paid, is to be excluded from the calculation of consideration for a taxable assignment sale. These changes will be effective for assignment agreements entered on or after May 7, 2022.

- **Introduction of federal excise duty on vaping products,** including solid or liquid vaping substances. Budget 2022 proposes to allow for a grace/transition period for retailers by allowing sales of unstamped products, that are in inventory as of October 1, 2022, up until January 1, 2023.

- **Elimination of excise duty on low-alcohol beer,** effective on July 1, 2022.

- **Changes to Cannabis Taxation Framework and general administration,** including to allow licensed cannabis producers to remit excise duties quarterly rather than monthly, the allowance of CRA to approve certain contracts for service arrangements between two licensed cannabis producers, to amend penalty provisions and to exempt holders of a Health Canada issued 'Research Licence or Cannabis Drug Licence' from the requirement to be licensed under the excise duty regime.

- **Expansion of the scope of the GST/HST health care rebate** by removing the eligibility for the rebate based on geographical location.

Other measures

- **Changes to the GAAR** to address policy concerns from a 2018 Federal Court of Appeal decision, which found that the GAAR did not apply to a transaction that resulted in an increase to a tax attribute that had not yet been utilized to reduce taxes. As a result of the amendments, GAAR can be applied to transactions that have not yet become relevant to the computation of tax. The modification is expected to be effective for notices of determination issued on or after April 7, 2022.

- **Announcements concerning the government's intention to undertake a review of the SR&ED program** to assess its effectiveness in encouraging research and development in Canada, as well as to explore opportunities to modernize and simplify the program, specifically examining whether changes to eligibility criteria would be warranted. In addition, the review will assess whether the tax system can play a role in the development and retention of intellectual property in Canada, with a focus on the appropriateness of **introducing a federal patent box regime.**

Public consultations

Announcement / confirmation of the government's intention to proceed with public consultations in respect of the following topics:

- **Employee ownership trust,** a new type of trust intended to facilitate employee ownership of businesses. No specific information about this intention was included in the Budget 2022, but rather an expectation to continue to consult on the approach to ultimately lead to the development of rules that would address such structures. There is no firm timing on when the consultations would conclude or when draft rules would be released.

- **Consideration of an alternative minimum tax regime for individuals.** Details of a proposed approach are expected to be released with the 2022 Fall Economic and Fiscal Update.

- **Intergenerational transfers of shares** with respect to previously passed bill C-208, which provided the legislative means for allowing shares of certain corporations to be transferred between generations without the incidence of tax. The consultation period is being held in order to address government concerns that the legislation introduced could be used to achieve ‘surplus stripping’ without a genuine intergenerational transfer taking place. The consultation period will run through to June 17, 2022.

- **Review of the rollover for small business investments**. The objective of this review is to assess whether the tax system is providing adequate support to investments in growing businesses. Specifically noted is an examination of the rollover provisions which allows for the deferral of tax on capital gains. No details or timelines were included.

- **Global minimum tax (Pillar Two).** The objective of this consultation is to ensure that draft legislation to implement the model rules in Canada considers any necessary adaptations to the Canadian tax and legal context. The consultation period will run through July 7, 2022.

- **Transfer pricing consultation previously announced in Budget 2021.**

- **The previously announced consultation on the modernization of the GAAR.** A public consultation period will run through the summer of 2022, with draft legislation expected to be released by the end of the year.

Personal measures

- **Creation of the tax-free first home savings account (FHSA)**, allowing individuals to contribute up to $8,000 per year (and $40,000 over their lifetime), with the contributions being deductible to the taxpayer, income earned in the FHSA being tax-free, and withdrawals for the purchase of a first home being non-taxable. The first contribution is expected to be available in 2023.

- **Expansion of the home buyer tax credit**, providing up to $1,500 in tax relief to eligible first-time home buyers on acquisitions made on or after January 1, 2022.

- **Introduction of the multigenerational home renovation tax credit and home accessibility tax credit**, taking effect in 2023, to provide a refundable credit of 15% of up to $50,000 of eligible expenses for the purposes of a renovation that creates a second dwelling unit for an eligible person to occupy with a parent, child, grandchild, brother, sister, uncle, aunt, niece or nephew of the eligible person. Eligible persons include individuals who are 65 or older at the end of the year that includes the renovation period as well as adults with disabilities who are eligible for the disability tax credit.

- **Increase to the home accessibility tax credit**, raising the annual expense limit to $20,000, effectively increasing the maximum credit to $3,000. This will apply to expenses incurred in 2022 and subsequent years.

- **Introduction of a residential property flipping rule**, taking effect for residential properties sold after 2022, which would deem residential property that was disposed of within 12 months of acquisition to be business income. Thus, the property would not be eligible for capital gain rates or other exemptions such as the principal residence exemption, unless certain “life event” exceptions arose such as death, illness, employment changes, or a number of other events.

In addition to housing-related measures, other announced modifications include:

- **Introduction of a labour mobility deduction for tradespeople**, providing up to $4,000 of deduction per year where an individual incurs eligible expenses to temporarily relocate to obtain or maintain employment in a construction activity.

- **Expansion of medical expense tax credits** to include costs related to surrogacy and other expenses.

- **Consultation on a potential career extension tax credit** aimed at boosting labour force participation by seniors who want to continue to work. No details or timing related to such a credit were provided.

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