Federal Budget 2022 – Shifting focus: Transitioning out of a COVID economy

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The 2022 Federal Budget (Budget 2022) tabled on April 7, 2022 (Budget Day) sets its sights on moving on from COVID measures to building the Canada that follows. Budget 2022, presented by Deputy Prime Minister and Minister of Finance Chrystia Freeland, focused on housing, productivity, and the environment.

In addition to the tax measures discussed in more depth below, the Government is looking to make investments on what it sees as key issues confronting Canada in the next five years. On the housing front, a new housing accelerator fund and targeted investments in new home building, new rental units, and affordable housing combine with increased funding to existing programs for more than $10 billion in additional spending over the next five years. The Government will also review the use of housing as an asset class by large investors and will institute a two-year prohibition on foreign commercial enterprises acquiring non-recreational residential properties.

To increase productivity, in addition to expected improvements in workforce participation by women due to the implementation of affordable childcare, the Government is looking at creating a new Innovation and Investment Agency and investing in programs targeted at mining critical minerals, resource development supply chains, and benefits-sharing arrangements with Indigenous communities. The Government also signaled its intention to modernize both the SR&ED research tax incentive program and the *Competition Act* (Canada).

As with previous budgets, the Government has increased funding for green initiatives. Sales mandates for zero emissions vehicles are to be put in place, supported by continuing incentives for buyers and a national network of charging stations. In addition, Budget 2022 includes a new Canada Water Agency to protect freshwater, tax credits for carbon capture, investments in clean energy including small modular reactors, and funding for wildfire control.

While it may not be enough for fiscal hawks, the deficit is projected to decrease significantly (from $113.8 billion in fiscal 2021-22 to $52.8 billion in fiscal 2022-23) and the Government has reaffirmed its commitment to the debt-to-GDP ratio, with Freeland stating: “This is our fiscal anchor – a line we shall not cross…”. Projections see this measure back on the pre-pandemic track by fiscal 2026-27.

Business Income Tax Measures

Canada Recovery Dividend (CRD) and additional tax on banks and life insurers

Budget 2022 proposes two new measures aimed at ensuring financial institutions help pay for the more than $350 billion spent fighting the COVID pandemic, on the basis that they made significant profits during the pandemic and recovered faster than other parts of the economy.

Budget 2022 proposes to introduce the CRD, a one-time 15 per cent tax on bank and life insurer groups. The CRD would be determined based on a corporation's taxable income for taxation years ending in 2021, payable in equal parts over five years beginning in 2022. Groups subject to the CRD will be permitted to allocate a $1 billion taxable income exemption amongst group members. An additional 1.5 per cent income tax will apply to taxation years ending after Budget Day. Groups subject to the additional 1.5 per cent income tax will be permitted to allocate a $100 million taxable income exemption amongst group members.

Investment tax credit for carbon capture, utilization, and storage

Budget 2022 proposes to introduce an investment tax credit for carbon capture, utilization, and storage (CCUS). The CCUS tax credit would be refundable and available to businesses that incur eligible expenses starting January 1, 2022. Eligible expenses would include the cost of purchasing and installing eligible equipment used in an eligible CCUS project, so long as the equipment was part of a project where the captured CO2 was put to an eligible use.

In order to claim the CCUS tax credit, the CCUS project would be subject to the following requirements: validation and verification process; certain storage requirements; and climate-related financial disclosure.

Eligible expense incurred after 2021 through 2030 will be subject to favorable tax credit rates, which would range from 37.5 per cent to 60 per cent depending on the type of CCUS equipment. For tax years after 2030 through 2040, the rates would vary from 18.75 per cent to 30 per cent, depending on the type of CCUS equipment.

In addition, CCUS equipment would be included in two new capital cost allowance classes that would range from 8 per cent to 20 per cent, with respect to specific equipment to capture and store CO2. These classes would be eligible for enhanced first year depreciation under the Accelerated Investment Incentive.

This measure would apply to eligible expenses incurred after 2021 and before 2041.

Clean technology tax incentives: Air-source heat pumps

An air-source heat pump is a device that uses electrical energy to provide interior space heating or cooling by exchanging heat with the outside air. It is an alternative to fossil fuels for heating or providing a more efficient means of heating with electricity. Budget

2022 proposes to expand eligibility under the accelerated capital cost allowance classes 43.1 and 43.2 to include air-source heat pumps primarily used for space or water heating.

Additionally, in accordance with the temporary measure to reduce corporate income tax rates for qualifying zero-emission technology manufacturers implemented in Budget 2021, Budget 2022 proposes to include the manufacturing of air-source heat pumps used for space or water heating as an eligible zero-emission technology manufacturing or processing activity. Consequently, the manufacturers of air-source heat pumps will have a reduced tax rate on eligible income of 7.5 per cent, where that income would otherwise be taxed at the 15 per cent general corporate tax rate and 4.5 per cent, where that income would otherwise be taxed at the 9 per cent reduced small business tax rate.

Flow-through shares for oil, gas, and coal activities, and the Critical Mineral Exploration Tax Credit

Flow-through shares are a tax incentive that allow investors to claim a deduction and/or credit for expenditures incurred by a corporation in which they acquire shares. Flow-through shares can be an effective financing vehicle for higher risk activities that the Government wishes to incentivize. Historically, the flow-through share regime has focused on incentivizing mining and oil and gas exploration and development, although in recent years there has been expansion toward expenditures incurred in the renewable energy context.

Budget 2022 will further tailor the flow-through share rules toward the Government’s clean technology mandate. Specifically:

- **Oil, gas and coal activities:** Budget 2022 proposes to eliminate the flow-through share regime entirely for oil, gas and coal activities, by no longer allowing oil, gas and coal exploration and development expenditures to be renounced to a flow-through share investor. This change would apply to expenditures renounced under flow-through share agreements entered into after March 31, 2023.
- **Critical minerals (batteries, etc.):** Budget 2022 proposes to introduce a new 30 per cent Critical Mineral Exploration Tax Credit (CMETC) for the exploration for (but not development of) specified minerals that, generally, are used in the production of batteries and permanent magnets, or are necessary in the production and processing of advanced materials, clean technology or semi-conductors. Mining for the following would be eligible: Copper, Nickel, Lithium, Cobalt, Graphite, Rare Earth Elements, Scandium, Titanium, Gallium, Vanadium, Tellurium, Magnesium, Zinc, Platinum Group Metals and Uranium. The CMETC can be renounced to flow-through share investors, which is a welcome addition for mining companies that will further Canada’s integration in the zero-emission vehicle and clean technology supply chain, and a welcome incentive for investors who can play their part in financing the same. Companies can start raising capital under this program immediately.

Small business deduction (SBD)

In order to sustain small business growth, Budget 2022 allows small businesses to benefit from a reduced corporate income tax rate of 9 per cent relative to the general corporate income tax rate of 15 per cent through the SBD. The SBD of 6 per cent applies on up to $500,000 per year of qualifying active business income of a Canadian-controlled private corporation (CCPC). Prior to Budget 2022, CCPCs and associated corporations with a combined taxable capital employed in Canada between $10 million and $15 million would lose a portion of the SBD based on a gradual basis, with the SBD being completely eliminated where the taxable capital employed exceeded $15 million.

Budget 2022 proposes to extend the range over which the SBD is reduced based on the combined taxable capital employed in Canada of the CCPC and its associated corporations. The new range would be $10 million to $50 million. This change would allow more medium-sized CCPCs to benefit from the SBD. This business limit may be reduced under certain circumstances, which could increase a CCPC's marginal tax rate.

Insurance contracts

The International Financial Reporting Standards for Insurance Contracts (IFRS 17) will take effect in 2023. On May 28, 2021, the Government announced that it intends to generally support the use of IFRS 17 accounting for income tax purposes, but the IFRS 17 Reserve would not be considered a deductible reserve for tax purposes (the News Release). Budget 2022 maintains the policy intent of the News Release, but proposes to make the following relieving modifications resulting from recent consultations with the insurance industry:

- **Life insurance:**
  - *Segregated funds:* IFRS 17 Reserve associated with segregated funds is proposed to be fully deductible.
  - *Life insurance contracts other than segregated funds:* 10 per cent of the IFRS 17 Reserve is proposed to be deductible for tax purposes and then included in income for tax purposes when the non-attributable expenses are later incurred.
  - *Part VI tax:* Inclusion of the following in the tax base for Part VI tax: (i) the non-deductible IFRS 17 Reserve; and (ii) accumulated other comprehensive income amounts arising from the reclassification of gains and losses on certain fixed income assets from retained earnings. Budget 2022 also proposes that deferred tax assets will not be deducted from the Part VI tax base for life insurers.
- **Mortgage and title insurance:** 10 per cent of the IFRS 17 Reserve is proposed to be deductible for tax purposes and then included in income for tax purposes when the non-attributable expenses are later incurred.
- **Property and casualty insurance:** Maintain the current tax treatment for property and casualty insurance contracts (other than title and mortgage insurance contracts).

Hedging and short selling by Canadian financial institutions

Generally, taxpayers must include any dividends they receive in their income. However, corporations are generally entitled to a corresponding deduction for dividends received from a taxable Canadian corporation or from a corporation resident in Canada that the corporate taxpayer controls. This deduction, often referred to as the inter-corporate dividend deduction, enables income earned by a corporation and subject to tax to pass between corporations tax-free in order to avoid excessive taxation. The inter-corporate dividend deduction is a key pillar of income tax integration.

However, the *Income Tax Act* contains a number of provisions that deny the inter-corporate dividend deduction in prescribed circumstances. For example, an inter-corporate dividend deduction is denied in respect of a dividend received by a corporation as part of a "dividend rental arrangement." A dividend rental arrangement generally entails a taxpayer acquiring shares for the main reason of receiving a dividend under circumstances where another party bears the risk of loss or enjoys the opportunity for gain or profit with respect to the shares.

Budget 2022 notes the Government is concerned that certain taxpayers are engaging in arrangements that give rise to an inter-corporate dividend deduction in circumstances where other unintended tax benefits arise.

One example provided in Budget 2022 is where 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. The result is to eliminate the corporate group's economic exposure to the Canadian shares. From a tax perspective, the Canadian bank claims an inter-corporate dividend deduction and the registered securities dealer deducts two-thirds of the amount of the dividend compensation payments made to the lender of the shares.

Budget 2022 proposes to expand the definition of dividend rental arrangement to include specified hedging transactions, as proposed. The effect of these proposals will be to: (i) deny the inter-corporate dividend deduction in respect of dividends received by a taxpayer if a registered securities dealer (that does not deal at arm's length with the taxpayer) knowingly or under circumstances where it ought to have known, enters into transactions that hedge a taxpayer's economic exposure to the applicable shares; (ii) deny the inter-corporate dividend deduction for dividends received by a registered securities dealer on Canadian shares that it holds if it eliminates all or substantially all of its economic exposure to the shares by entering into specified hedging transactions; and (iii) where the inter-corporate dividend is denied as noted in (i) or (ii), the registered securities dealer will be entitled to a full, rather than a two-thirds, deduction for its dividend compensation payment.

The proposals will apply to dividends and related dividend compensation payments paid or that become payable on or after April 7, 2022. However, where the relevant hedging transaction or related securities lending arrangement was in existence prior to April 7, 2022, the proposals apply to dividends and related dividend compensation payments that are paid after September 2022.

Application of the General Anti-Avoidance Rule (GAAR) to tax attributes

Budget 2022 proposes that the *Income Tax Act* be amended to address the 2018 Federal Court of Appeal decision in *1245989 Alberta Ltd. v Canada (Attorney General)*, which held that the GAAR did not apply to a transaction that resulted in an increase in a tax attribute that had not yet been utilized to reduce taxes. Budget 2022 proposes that the *Income Tax Act* be amended to provide that the GAAR can apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax, mainly by expanding the definition of “tax benefit” and “tax consequences.” This measure would apply to notices of determination issued on or after Budget Day.

Genuine intergenerational share transfers

In June 2021, Private Member’s Bill C-208 received royal assent, which amended the *Income Tax Act* to facilitate intergenerational business transfers. At that time, Finance expressed concerns that these changes may permit surplus stripping without a genuine intergenerational transfer of the business and signaled its intention to bring forward amendments for consultation. Budget 2022 announces the Government’s intention to consult on such amendments and requests comments from stakeholders (in particular from the agriculture industry) by June 17, 2022, with a bill to be tabled this fall.

Substantive CCPCs

Under the current system, investment income earned by CCPCs is subject to an additional refundable tax. Non-CCPCs, such as public corporations and companies controlled by foreign shareholders, are not subject to the additional refundable tax on investment income. The refundable tax is part of the “integration” system, which generally attempts to tax income earned personally at the same rate as income earned through a corporation.

The refundable tax system applies with respect to investment income, which generally includes portfolio dividends, capital gains, interest, rent, royalties and foreign accrual property income (FAPI). The refundable tax on CCPCs is generally refunded to the corporation once it pays sufficient taxable dividends to its shareholders. The CRA has challenged several taxpayers, alleging that the taxpayer manipulated CCPC status to avoid refundable tax in a manner that offends the GAAR. To date there have been no court decisions on point.

Budget 2022 proposes that “substantive CCPCs” will be subject to the refundable tax on investment income, but would continue to be treated as non-CCPCs for all other purposes of the *Income Tax Act*. Substantive CCPCs will mean private corporations resident in Canada (other than CCPCs) that are ultimately controlled (in law or in fact) by Canadian-resident individuals. The test will contain an extended definition of control that aggregates the shares owned, directly or indirectly, by Canadian resident individuals, and would therefore deem a corporation to be controlled by a Canadian resident individual where Canadian individuals own, in aggregate, sufficient shares to control the corporation. The measure does not apply to private corporations that are ultimately controlled by non-resident persons and subsidiaries of public corporations. The measure would also cause a corporation to 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.

This measure would apply to taxation years of the Canadian corporation that end on or after Budget Day. However, to provide certainty for genuine commercial transactions entered into before Budget Day, an exception to the coming-into-force rule would be provided where the taxation year of the Canadian 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. The purchase and sale agreement pursuant to which the acquisition of control occurs must have been entered into before Budget Day and the share sale must occur before the end of 2022.

Investment income earned through controlled foreign affiliates

Budget 2022 proposes to eliminate the potential tax-deferral advantage available to CCPCs and their shareholders earning investment income through controlled foreign affiliates (CFAs) by reducing the deduction available for foreign taxes paid on FAPI earned through a CFA. This change eliminates any tax incentive for CCPCs and their shareholders to earn investment income in a CFA, as refundable tax will apply to the CCPC/substantive CCPC to the extent that the foreign tax is less than 52.63 per cent.

Additional changes are proposed regarding the treatment of taxable surplus and hybrid surplus dividends received from foreign affiliates by CCPCs/substantive CCPCs to further extend the reach of the refundable tax. Overall, these changes appear to apply refundable tax on FAPI, taxable surplus and hybrid surplus (unless it has borne tax of at least 52.63 per cent), but the treatment of active business income from treaty countries (i.e., exempt surplus) remains unaffected. Also, a new method to achieve partial shareholder/corporate tax integration will be applied whereby the CCPC/substantive CCPC's capital dividend account calculation will include income received from CFAs that has effectively borne tax of at least 52.63 per cent.

Personal Income Tax Measures

Registered plans

Budget 2022 proposes to create a new registered account to help individuals save for their first home, the "Tax-Free First Home Savings Account" or "FHSA." Similar to RRSPs, contributions to an FHSA would be deductible and income earned in an FHSA would not be subject to tax. Similar to TFSAs, qualifying withdrawals from an FHSA made to purchase a first home would be non-taxable. Although no detailed legislative proposals were included, Budget 2022 provides insights of the following key design features:

- Lifetime limit on contributions would be $40,000, subject to an annual contribution limit of $8,000;
- Eligible to individuals resident in Canada that are at least 18 years of age;
- Eligible in respect of first home purchases provided that the individual did not live in the home at any time in the year the account is opened, or during the preceding four calendar years;
- Amounts withdrawn to make a qualifying first home purchase would not be subject to tax, and any other withdrawals, including on the account's closing, would be taxable, though in some cases amounts can be rolled into an RRSP or RRIF without triggering tax;
- The individual would be required to close their FHSA within a year from the first withdrawal and would not be eligible to open another FHSA; and
- The FHSA will also have to be closed if the individual has not used the funds for a qualifying first home purchase within 15 years of the account's opening, though in some cases amounts can be rolled into an RRSP or RRIF without triggering tax.

The FHSA is essentially a replacement or substitute for the existing home buyer's plan (HBP), which allows individuals to withdraw up to $35,000 from an RRSP to purchase or build a home without having to pay tax on the withdrawal. Budget 2022 indicates that the HBP will continue to be available under existing rules. However, an individual will not be permitted to make both an FHSA withdrawal and an HBP withdrawal in respect of the same qualifying home purchase.

Budget 2022 indicates that the Government would work with financial institutions to have the infrastructure in place for individuals to be able to open an FHSA and start contributing at some point in 2023.

Some financial institutions, however, may be cautious of entering this new registered account marketplace when they consider that Budget 2022 also introduces new reporting requirements for some of their existing registered plans. Budget 2022 proposes to require financial institutions to annually report to the CRA the total fair market value, determined at the end of the calendar year, of property held in each RRSP and RRIF that they administer.

This new measure is likely the fallout from the recent decision in the 2021 Tax Court of Canada decision in *Grenon v The Queen*, which is being appealed to the Federal Court of Appeal. As indicated in Budget 2022, it is hoped that the new information obtained from the financial institutions would assist the CRA in its risk-assessment activities regarding qualified investments held by RRSPs and RRIFs. This measure would apply to the 2023 and subsequent taxation years.

Residential property flipping rule

Budget 2022 proposes a new deeming rule to ensure that profits from certain residential real estate transactions (referred to as property flipping) are subject to full taxation, rather than being taxed as capital gains. The concern expressed is that certain individuals engaged in flipping residential real estate are not properly reporting their profits as business income (which is fully taxable), but instead are reporting their profits as capital gains and, in some cases, claiming the principal residence exemption (resulting in zero taxation). Under the proposed new deeming rule, profits arising from dispositions of residential property (including rental property) owned for less than 12 months would be deemed to be business income.

The deeming rule would not apply if the disposition is in relation to at least one of certain listed life events: death; household addition (e.g., birth of a child); separation; personal safety; disability or illness; employment change (for a new work location the new home must be at least 40km closer); insolvency; or an involuntary disposition (e.g., expropriation). Where the new deeming rule applies, the principal residence exemption would not be available. Where the deeming rule does not apply because of one of the listed life events or because the property had been owned for 12 months or more, it would remain a question of fact whether the profits from the disposition are business income or a capital gain. This proposed measure would apply in respect of residential properties sold on or after January 1, 2023.

Borrowing by defined benefit pension plans

Registered pension plans are subject to restrictions imposed under the Regulations to the *Income Tax Act* on borrowing money. Generally, where the borrowing is other than for the purpose of acquiring income producing real property, the term of the loan must not exceed 90 days and the property of the plan cannot be pledged as security for the loan. Budget 2022 proposes to provide more borrowing flexibility to administrators of defined benefit registered pension plans (other than individual pension plans) by replacing the 90-day term limit and restriction on pledging plan property with a limit on the total amount of additional borrowed money (for purposes other than acquiring real property), equal to the lesser of:

- 20 per cent of the value of the plan's assets (net of unpaid borrowed amounts); and
- The amount, if any, by which 125 per cent of the plan's actuarial liabilities exceeds the value of the plan's assets (net of unpaid borrowed amounts).

The new borrowing limit would be redetermined on the first day of each fiscal year of the plan, based on the value of assets and unpaid borrowed amounts on that day and the actuarial liabilities on the effective date of the plan's most recent actuarial valuation report. Each redetermined limit would not apply to borrowings entered into before that time.

Plan administrators must continue to comply with the provisions of federal or provincial pension benefit standards legislation.

This measure would apply to amounts borrowed by defined benefit registered pension plans (other than individual pension plans) on or after Budget Day.

Other personal income tax matters

- **Home Buyers' Tax Credit (HBTC):** Budget 2022 proposes to double the HBTC amount from $5,000 to $10,000. This measure applies to acquisitions of a qualifying home made on or after January 1, 2022.
- **Home Accessibility Tax Credit (HATC):** Budget 2022 proposes to increase the annual expense limit of the HATC from $10,000 to $20,000. The measure applies to expenses incurred in the 2022 and subsequent taxation years.
- **Multigenerational Home Renovation Tax Credit (MHRTC):** Budget 2022 proposes to introduce the MHRTC, which is a refundable tax credit that would provide recognition of eligible expenses for a home renovation that creates a secondary dwelling unit for a "qualifying person" (i.e., a senior or a person with a disability) to live with certain family members. The value of the credit is 15 per cent of the lesser of the eligible expenses and $50,000. This measure applies for the 2023 and subsequent taxation years.
- **Labour Mobility Deduction for Tradespeople (LMDT):** Budget 2022 proposes to introduce the LMDT to recognize certain travel and relocation expenses of workers in the construction industry. This measure would allow eligible workers to deduct up to $4,000 in eligible expenses per year. This measure would apply to the 2022 and subsequent taxation years.
- **Medical Expense Tax Credit (METC) for surrogacy and other expenses:** Budget 2022 proposes to allow a taxpayer to claim the METC in respect of qualifying medical expenses incurred by a surrogate mother or donor that are reimbursed by the taxpayer. Budget 2022 also proposes to allow fees paid to

fertility clinics and donor banks in Canada for purposes of obtaining donor sperm and ova to be eligible under the METC. These measures would apply to expenses incurred in the 2022 and subsequent taxation years.

Registered Charities

Annual disbursement quota (DQ) for registered charities

Budget 2022 proposes to introduce a new graduated DQ rate for registered charities in respect of their fiscal periods beginning on or after January 1, 2023. For investment assets exceeding $1 million, the DQ rate will increase from 3.5 per cent to 5 per cent.

These measures are intended to increase expenditures by charities overall, while accommodating smaller grant-making charities that may not be able to realize the same investment returns as larger charities. The DQ rate increase will have a significant impact on charitable foundations with large endowments subject to capital payment restrictions. Court applications to vary the terms of these endowment funds may be required to expend capital, given investment rates.

In addition, Budget 2022 proposes to amend the *Income Tax Act* to:

- Clarify that expenditures for administration and management are not considered qualifying expenditures for the purpose of satisfying a charity's DQ;
- Give the CRA the discretion to grant a reduction in a charity's DQ obligation for any particular tax year and allow the CRA to publicly disclose information relating to such a decision; and
- Remove the accumulation of property rule, which allowed charities to apply to the CRA for permission to accumulate property for a specific purpose and not include the property accumulated in accordance with the approval, including any income earned, in calculating the charity's DQ.

Charitable partnerships

Budget 2022 proposes to allow registered charities to make grants to organizations that are not qualified donees (e.g., non-profit organizations), provided these grants are in furtherance of the charity's charitable purposes and the charity ensures that the funds are applied to charitable activities by the grantee.

Charities will be required to meet certain mandatory accountability requirements defined in the *Income Tax Act* that are designed to ensure their resources will be used for charitable purposes, including conducting a review of the grantee, having a written agreement between the charity and the grantee, monitoring the grantee, and receiving full and detailed final reports from the grantee. These measures will make it easier for registered charities to partner with non-charities without having to enter into complex arrangements.

Budget 2022 proposes to require charities to, upon request by the CRA, take all reasonable steps to obtain receipts, invoices, or other documentary evidence from grantees to demonstrate amounts were spent appropriately. And, to address charities acting as a conduit for donations to other organizations, Budget 2022 proposes to prohibit registered charities from accepting gifts, the granting of which was expressly or implicitly conditional on making a gift to a person other than a qualified donee.

These changes will apply as of royal assent of the enacting legislation.

International Tax Measures

International tax reform

The Organization for Economic Co-operation and Development (OECD) has announced measures to more equitably reallocate amongst countries the tax revenues generated by the digital economy and social media businesses. The so-called “Pillar One” is intended to reallocate a portion of taxing rights over the profits of the largest and most profitable multinational enterprises (MNEs) to the countries where their users and customers are located. The so-called “Pillar Two” is intended to ensure that the profits of a different group of MNEs are subject to an effective tax rate of at least 15 per cent, regardless of where they are earned.

Budget 2022 announces Canada’s intention to proceed with the implementation of both of these measures, and sets out the proposed timetable for doing so.

Pillar 1: Reallocation of taxing rights

Traditionally, the right to tax a business that is a resident of one country (the Residence State) on income earned through business activities carried on in another country (the Source State) has been allocated on the basis of the “permanent establishment” concept. This means the Source State may only tax profits to the extent they are attributable to a “permanent establishment” located within the Source State. The increasing digitalization of international commerce has made it easier to earn business profits in other countries without having a permanent establishment (i.e., a physical place of business) in those countries.

Under Pillar 1, a new framework is being proposed for allocating the right to tax the global profits of large multinational entities (MNEs). Essentially, MNEs with global revenue of more that €20 billion and a profit margin of more than 10 per cent will be subject to a complex new regime for allocating more profits (and the associated right to tax them) to the countries where the goods and services being produced are used or consumed. Budget 2022 expresses Canada’s intent to implement the Pillar 1 measures once the countries agree on the final terms multilaterally.

Budget 2022 also expresses its intention to proceed with the “back-up plan” of a digital services tax (imposed as of 2024, but applied retroactively back to 2022) in the event that no multilateral convention implementing Pillar 1 has been agreed to by 2024.

Pillar 2: Global minimum tax

The general intention behind Pillar 2 is to ensure that multinational companies with annual worldwide revenue of €750 million or more are subject to a minimum effective tax rate of 15 per cent of their profits in every jurisdiction in which they operate. Pillar 2 will generally be implemented by means of a multilateral tax convention that would serve to amend the tax treaties that exist between countries.

Budget 2022 announces Canada’s intent to implement Pillar 2, including a domestic minimum top-up tax applicable to MNEs with Canadian parent companies within the scope of Pillar 2. To this end, Canada proposes to launch a public consultation on the measures. Portions of the tax measures would come into force in 2023, and the balance in 2024.

The proposed enactment of Pillar 2 has been the subject of considerable criticism within the Canadian tax community for various reasons, including the extremely complex computations that would be required and uncertainty over how much tax revenue would actually be generated in Canada.

Exchange of tax information on digital economy platform seller

Budget 2022 proposes to require certain digital platform operators to evaluate the tax residency of their sellers and to report information about their sellers. The European Union, United Kingdom and Australia are expected to implement similar rules. This measure would apply to calendar years beginning after 2023. Therefore, the first reporting and exchange of information would take place in early 2025 with respect to the 2024 calendar year.

The reporting measure would generally apply to platform operators that are tax resident in Canada, and to certain platform operators that are not resident of Canada but who facilitate activities of Canadian-resident sellers or of persons who rent Canadian real estate. The measure would exclude small platform operators whose total revenues from such activities over the previous year is less than €1 million. Digital platforms that facilitate payment processing, that are classified ads boards, or that transfer users to another platform (i.e., online aggregators) would also not be required to report under these new rules.

The digital platform operator would be required to report information about a “reportable seller.” A reportable seller would be selling goods or providing services on the digital platform. In addition, specifically included under the reporting provisions would be services related to the rental of real estate property and parking spaces situated in Canada. Sellers that represent a limited compliance risk would not be reportable sellers. Further, small sellers who make less than 30 sales a year for a total of not more than €2,000 during the year would be excluded.

Reporting platform operators would need to complete due diligence procedures to identify reportable sellers and their jurisdiction of tax residence. Reporting platform operators would be required to report to the CRA specified information on reportable sellers by January 31 of the year following the calendar year for which a seller is identified as a reportable seller. Similar information would also be required to be provided to each reportable seller on the digital platform.

The CRA would automatically exchange with partner jurisdictions (i.e., partner jurisdictions that have implemented similar reporting provision) the information received from Canadian platform operators on sellers resident in the partner jurisdiction, and rental property located in the partner jurisdiction. Likewise, the CRA would receive information on Canadian sellers and rental property located in Canada from partner jurisdictions. The exchanges would take place under the exchange of information provisions in tax treaties.

Interest coupon stripping

Non-residents of Canada are generally liable to pay withholding tax levied pursuant to Part XIII of the *Income Tax Act* on certain Canadian source passive income. Withholding tax is payable on every amount that a person resident in Canada pays or credits, or is deemed to pay or credit, to a non-resident of Canada as, on account of, in lieu of payment of, or in satisfaction of certain specific enumerated items, including certain interest payments. Withholding tax levied pursuant to Part XIII of the *Income Tax Act* is payable at the rate of 25 per cent (subject to reduction under an applicable treaty) and is calculated based on the gross amount paid or credited to the non-resident of Canada.

Presently and subject to an applicable income tax convention, interest that is paid or payable by a Canadian resident to a non-resident will be subject to withholding tax if the interest is paid or payable (i) to a person with whom the Canadian resident is not dealing at arm's length, or (ii) in respect of a debt or other obligation to pay an amount to a person with whom the payer is not dealing at arm's length. Where the non-resident is a resident of a country with which Canada has entered into a bilateral tax treaty, the rate of withholding tax applicable to interest is generally reduced to 10 per cent or 15 per cent. One exception is the Canada-U.S. tax treaty, which generally reduces the withholding tax rate to nil.

Budget 2022 notes that taxpayers have avoided paying withholding tax in respect of interest payable on non-arm's length debt using interest coupon stripping arrangements. An interest coupon stripping arrangement generally entails a sale of interest rights by a non-arm's length creditor to an arm's length purchaser that is a resident of a favourable tax treaty jurisdiction, with the effect that the interest is not subject to withholding tax (if the purchaser is a resident of the U.S. and is entitled to benefits under the Canada-U.S. tax treaty) or is subject to a lower rate of withholding tax (10 per cent to 15 per cent where the purchaser is a resident of a jurisdiction that Canada has entered into a bilateral tax treaty with, other than the U.S.).

Part XIII of the *Income Tax Act* was previously amended in 2011 to deal with interest coupon stripping arrangements. Those amendments statutorily overruled the 2010 Federal Court of Appeal decision in *Lehigh Cement Limited v Canada*. Interestingly, the continued use of interest coupon stripping arrangements appears to have been contemplated by Finance in 2011, since its backgrounder to the 2011 amendments stated: "The ITA be amended to clarify that withholding tax under Part XIII of the ITA will apply subject to the application of Canada's tax treaties…".

Budget 2022 proposes to further amend Part XIII of the *Income Tax Act* to ensure that withholding tax cannot be reduced or avoided using interest coupon stripping arrangements. To achieve this result, Budget 2022 proposes to add a number of provisions to the *Income Tax Act* that will apply withholding tax in respect of an interest coupon stripping transaction as if the arrangement had not been undertaken. Specifically, where proposed subsection 212(22) of the *Income Tax Act* applies, the Canadian resident borrower in respect of an interest coupon stripping arrangement is deemed, for withholding tax purposes, to have paid an amount of interest to the non-resident lender that is subject to withholding tax at the rate otherwise reduced by virtue of the interest coupon stripping arrangement.

Proposed subsection 212(22) of the *Income Tax Act* will apply where the conditions set out in proposed subsection 212(21) of the *Income Tax Act* are met. It provides that proposed subsection 212(22) of the *Income Tax Act* will apply at any time in respect of a taxpayer if: (i) a Canadian-resident borrower pays or credits interest to a person or partnership (an interest coupon holder) in respect of 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 (a non-resident lender); and (ii) the withholding tax that would otherwise be payable under Part XIII of the *Income Tax Act* in respect of the interest, if paid to the non-resident lender, is greater than the withholding tax otherwise payable in respect of the interest coupon stripping arrangement.

Publicly offered debt obligations, as defined, are not subject to proposed subsection 212(22) of the *Income Tax Act*. Publicly-offered debt obligations are defined in proposed subsection 212(23) of the Income Tax Act as a debt or other obligation that (i) was issued as part of an offering that is lawfully distributed to the public in accordance with a prospectus, registration statement or similar document filed with and, where required by law, accepted for filing by a public authority, and (ii) it can reasonably be considered that none of the main purposes of an arrangement is to avoid or reduce withholding tax otherwise payable by a non-resident person or partnership to whom the debt is owed.

The foregoing proposals apply to interest that accrues on or after April 7, 2022, with one exception. For interest coupon stripping arrangements entered into prior to April 7, 2022, the forgoing proposals will apply to interest that accrues from April 7, 2023.

Sales and Excise Tax Measures

GST/HST health care rebate

In order to recognize the role of nurse practitioners in providing health care services, Budget 2022 proposes to amend the GST/HST eligibility rules for the expanded hospital rebate. In order to be eligible, a charity or non-profit organization must deliver the health care service with the active involvement of, or on the recommendation of, either a physician or a nurse practitioner, irrespective of their geographical location. This measure would generally apply to rebate claim periods ending after Budget Day in respect of tax paid or payable after that date.

GST/HST on assignment sales by individuals

In order to provide greater certainty regarding the GST/HST treatment of assignment sales, Budget 2022 proposes to make all assignment sales in respect of newly constructed or substantially renovated residential housing taxable for GST/HST purposes. However, it is proposed that the amount attributable to the deposit be excluded from the consideration for a taxable assignment sale. Note that these changes could affect the GST New Housing Rebate or new housing rebate of the provincial component of the HST available in respect of a new home. This measure would apply in respect of any assignment agreement entered into on or after the day that is one month after Budget Day.

Taxation of vaping products

Key refinements to the proposed taxation framework for vaping products are proposed. The tax base would include vaping products that may or may not contain nicotine and have either liquid or solid vaping substances with an equivalency of 1 ml of liquid = 1 gram of solids. Excluded from this proposed tax would be vaping products produced by individuals for their personal use and vaping products already subject to the cannabis excise duty framework. The excise duty is to be based on the volume of vaping substance in each vaping product and levied at a rate of $1 per 2 ml, or fraction thereof, for the first 10 ml of vaping substance; and $1 per 10 ml, or fraction thereof, for volumes beyond that.

An additional duty rate in respect of dutiable vaping products intended for sale in a participating jurisdiction may be imposed where a province or territory chooses to participate in a co-ordinated vaping taxation regime administered by the Government. This additional duty rate for each participating province or territory would be equal to the proposed federal excise duty rate, so that the proposed combined rate would be $2 per 2 ml, or fraction thereof, for the first 10 ml of vaping substance, and $2 per 10 ml, or fraction thereof, for volumes beyond that.

Licensees would be required to apply an excise stamp with a specific colour and other unique markings indicating the provincial or territorial market in which the vaping product is intended to be sold. The proposed federal excise duty framework for vaping products would come into force on October 1, 2022. However, retailers could sell unstamped products that are in inventory as of October 1, 2022 until January 1, 2023.

Travellers returning to Canada would be allowed duty-free importations of unstamped vaping products for personal use of up to twelve vaping products of less than 10 ml; or, any combination of vaping products of 10 ml or more, so long as the total volume imported is below 120 ml.

Cannabis taxation framework and general and administration under the *Excise Act, 2001*

Budget 2022 proposes to allow licensed cannabis producers to remit excise duties on a quarterly basis effective in respect of a fiscal quarter, beginning on or after April 1, 2022, and only if the licensee that was required to remit less than a total of $1 million in excise duties during the four fiscal quarters immediately preceding that fiscal quarter.

Budget 2022 proposes to allow the CRA to approve certain contract-for-service arrangements between two licensed cannabis producers including transferring stamps, and packaged but unstamped products, between them; stamp and enter cannabis products into the retail market that have been packaged by the other producer; and pay the excise duty on cannabis products that were stamped by the other producer. This proposal would come into force upon royal assent.

Budget 2022 proposes to amend the penalty provision for lost stamps so that the higher penalty for losing stamps for a province or territory with an additional cannabis duty adjustment only applies if the adjustment rate is greater than 0 per cent. In addition, Budget 2022 proposes that existing cannabis penalty provisions would also apply to situations where unlicensed parties illegally possess or purchase cannabis products, and where licensed parties illegally distribute cannabis products. These proposals would come into force upon royal assent.

Budget 2022 proposes to eliminate the requirement to be licensed under the excise duty regime for holders of a Health Canada-issued Research Licence or a Cannabis Drug Licence. In addition, Budget 2022 proposes to allow the CRA to issue excise duty licences that would be valid for up to the lesser of five years or the longest period for which the relevant Health Canada licence or licences are valid. These proposals would come into force upon royal assent.

Budget 2022 proposes to harmonize the suspension criteria for an excise licence with the criteria that is used to cancel an excise licence. In addition, Budget 2022 proposes to require all excise applicants and licensees to comply with federal and provincial legislation and regulations regarding the taxation and control of cannabis products. Budget 2022 also proposes to reduce the types of financial security that could be accepted by the CRA, including removing cash and transferable bonds issued by the Government of Canada, and add bank drafts and Canada Post money orders from the forms of security accepted. Finally, Budget 2022 proposes to confirm that CRA may, at its discretion, continue to carry out virtual audits and reviews of all licensees. These proposals would come into force upon royal assent.

100 per cent Canadian wine exemption removed

Wine is subject to excise duties under the *Excise Act, 2001*. However, 100 per cent Canadian wine is exempt from excise duties. This exemption was challenged at the World Trade Organization. Budget 2022 proposes to repeal the excise duty exemption effective June 30, 2022.

Beer taxation

Excise duty is proposed to be eliminated on July 1, 2022 for beer containing no more than 0.5 per cent ABV. This measure will bring the taxation of low alcohol beer into line with the treatment of low alcohol wine and spirits.

Other Measures

A new minimum tax regime

Budget 2022 announces that the Government will release a detailed proposal for a new minimum tax regime as part of its 2022 fall economic and fiscal update. While Budget 2022 provides little information about what this new minimum tax may look like, we expect that it may be a significant change for many taxpayers.

The *Income Tax Act* includes an Alternative Minimum Tax (AMT) regime that prevents taxpayers from using certain tax preference items to reduce their tax liability below a threshold rate of 15 per cent of adjusted taxable income before accounting for allowable deductions and credits. To determine their tax payable, taxpayers are required to calculate their tax liability using the normal method and the AMT method, then pay the greater of the two amounts. Taxpayers may also be subject to provincial AMT, which is typically calculated as a percentage of the federal AMT.

Tax preference items targeted by the existing AMT include tax shelter deductions, interest expenses, carrying charges on tax shelter loans, employee stock option deductions, the lifetime capital gains exemption, Canadian dividend payments, and realized capital gains. However, the AMT continues to allow taxpayers to take advantage of many personal tax credits, including those for medical expenses and charitable donations.

The way tax payable is calculated under the existing AMT regime necessarily means that the federal portion of tax, for taxpayers subject to the AMT, will always be less than 15 per cent of the taxpayer's gross income. This is because the AMT is calculated based on adjusted taxable income less a $40,000 exemption amount. Note that adjusted taxable income is less than a gross income.

Nonetheless, Budget 2022 highlights that approximately 28 per cent of Canadians with a gross income in excess of $400,000 per year pay less than 15 per cent federal personal income tax. This may be a signal from the Government that a new minimum tax regime may be aimed at setting a minimum federal income tax rate of 15 per cent for taxpayers with gross income in excess of $400,000.

Publicly accessible beneficial ownership registry

The Government is fast tracking amendments to the *Canada Business Corporations Act* to implement a public and searchable beneficial ownership registry. The Government first proposed the searchable beneficial ownership registry for corporations in Budget 2021. The registry is now expected to be available by the end of 2023 instead of 2025. The Government will work with the provinces and territories to have a national approach. In addition, Budget 2022 announces the Government's intention to work with provincial and territorial partners to advance a national approach to a beneficial ownership registry of real property, similar to other countries including the United Kingdom.

Previously Announced Measures

Budget 2022 confirms the Government's intention to proceed with the following previously announced tax and related measures, as modified to take into account consultations and deliberations since their release:

- 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; and
    - 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 GST/HST joint venture election.

By

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