The Stikeman Elliott
Federal Budget Commentary 2022

April 7, 2022

Welcome to the Grand Illusion

Highlights

- Changes to address investment income earned and distributed by a private corporation that is "in substance", but is not technically, a Canadian-controlled private corporation
- Potential new minimum tax for high earners
- Amendments to the general anti-avoidance rule to address unused tax attributes
- New taxes applicable to banks and life insurers
- New rules with respect to hedging and short selling by Canadian financial institutions
- Expansion of the scope of existing interest coupon stripping rules
- Elimination of oil, gas, and coal flow-through shares and introduction of a new critical mineral exploration tax credit for flow-through share investors
- Additional support for carbon capture and clean technology
- Changes to the restrictions on borrowing by defined benefit pension plans
- Consultation process to tighten the surplus stripping rules that address intergenerational wealth transfers

Stikeman Elliott's Tax Group has prepared a commentary on the 2022 federal budget.

About Stikeman Elliott

Stikeman Elliott LLP is a global leader in Canadian business law, offering creative solutions to clients across Canada and around the world. The firm provides the highest quality counsel, decisive advice and workable solutions through offices located in Montréal, Toronto, Ottawa, Calgary, Vancouver, New York, London and Sydney.

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Investment Income of CCPCs – an End to 111(4)(e) Planning

Canadian-controlled private corporations (CCPCs) are subject to an additional refundable corporate income tax on investment income, including capital gains, which is intended to limit the opportunity for individual Canadian taxpayers to defer taxes that would otherwise be payable in respect of investment income earned directly by an individual Canadian by instead earning that investment income indirectly through a corporation. One approach that has been utilized by some taxpayers to avoid the anti-deferral regime applicable to a CCPC is to take steps to avoid the corporation having the status of a CCPC – either by ensuring that the corporation is technically not a "Canadian corporation" because it is governed by the laws of a foreign jurisdiction or by taking other steps to ensure that the corporation will not be viewed as being controlled by Canadians – in circumstances where the corporation is still substantively controlled by Canadian residents. In addition, in circumstances where a CCPC is intended to be sold to a non-resident or a public corporation, a common tax planning technique that has emerged in recent years involves taking steps to realize capital gains on certain assets (most commonly, goodwill) of the corporation during the period between the entering into of a purchase and sale agreement with the buyer and the final closing of the sale, as the corporation would generally no longer be classified as a CCPC during this period.

Budget 2022 proposes to end this sort of planning by introducing amendments that are intended to ensure that investment income earned and distributed by a private corporation that is "in substance", but is not technically, a CCPC is subject to the same taxation as investment income earned and distributed by an actual CCPC. For these purposes, a "Substantive CCPC" would be any private corporation resident in Canada (other than a CCPC) that is ultimately controlled (legally or factually) by Canadian resident individuals. An extended definition of control would also apply that would aggregate the shares owned, directly or indirectly, by Canadian resident individuals, and would operate to deem a corporation to be controlled by a Canadian resident individual where Canadian individuals own, in aggregate, sufficient shares to control the corporation. The proposals will also be buttressed by a broad anti-avoidance rule targeted at the avoidance of Substantive CCPC status.

It should be noted that Substantive CCPCs would continue to be treated as non-CCPCs for all purposes of the *Income Tax Act* (Canada) (Tax Act) other than with respect to the earning and distribution of investment income.

The proposed changes described above would generally apply to taxation years that end on or after April 7, 2022 (Budget Day). However, in order to provide some limited grandfathering with respect to transactions entered into before the date of the Budget, the application of the proposed changes would only begin to apply to a corporation for taxation years that begin on or after Budget Day if: (i) the first taxation year of the corporation that ends after Budget Day ends as a result of an acquisition of control caused by the sale of all or substantially all of the shares of a corporation to a purchaser that was arm's length with the corporation immediately prior to such acquisition of control; (ii) the purchase and sale agreement pursuant to which such share sale occurs was entered into in writing before Budget Day; and (iii) the share sale actually occurs before the end of 2022.

In addition to the foregoing changes, Budget 2022 also proposes a series of targeted amendments aimed at eliminating any tax-deferral advantage available to CCPCs and their shareholders from earning investment income through controlled foreign affiliates of the CCPC.

Minimum Tax for High Earners

Budget 2022 announced that the government is exploring a potential new minimum tax regime for high earners. While Budget 2022 provided little detail, a proposed approach is expected to be released in the 2022 Fall Economic and Fiscal Update. Budget 2022 stated that 28% of individuals with income above $400,000 paid an average federal personal income tax rate of 15% or less. This may suggest a potential income cut-off level and tax rate for this new alternative minimum tax regime.

Amendments to the General Anti-Avoidance Rule

The general anti-avoidance rule will be amended to allow it to be applied to a transaction or series of transactions that create tax attributes before the tax attributes are utilized by a taxpayer to reduce or defer tax or create a refund of tax. This amendment overturns case law that had reached a contrary result.

Taxation of Banks and Insurers

Canada Recovery Dividend

Budget 2022 proposes to introduce a "Canada Recovery Dividend" which is a one-time 15% tax on bank and life insurer groups. This tax is calculated on the group's taxable income for taxation years ending in 2021 which exceed $1 billion (such exemption to be shared amongst group members). This tax is imposed for the 2022 taxation year and is payable in equal amounts over five years.

Additional Tax on Banks and Life Insurers

Budget 2022 also proposes to impose an additional tax of 1.5% on the taxable income of members of bank and life insurer groups which exceeds $100 million (determined on a group basis). This additional tax will apply to taxation years that end after Budget Day with proration for taxation years which include Budget Day.

Changes to Reflect the Adoption of IFRS 17

Tax rules relating to insurance contracts will be revised to reflect the adoption of IFRS 17, the new accounting standards for insurance contracts. In brief, only 10% (100% for segregated funds) of the reserve known as the contract service margin (CSM) associated with life insurance contracts and mortgage and title insurance contracts will be deductible for income tax purposes. The capital tax rules applicable to insurance corporations will also be modified to avoid the erosion in the tax base that would otherwise result due to IFRS 17. These measures will apply as of January 1, 2023.

Hedging and Short Selling by Canadian Financial Institutions

The Tax Act contains rules which, in general terms, enable a Canadian corporation to claim a deduction in respect of dividends it receives from other Canadian corporations. However, the Tax Act also contains several provisions which limit the availability of this dividend received deduction in certain cases, including where the Canadian corporation is a party to a securities lending arrangement in respect of a Canadian share on which the dividend is received (an "underlying share"). In response to certain hedging and short selling transactions undertaken by financial institution groups that the Government considered to be inappropriate, Budget 2022 proposes to amend the Tax Act so as to deny the dividend received deduction in respect of dividends received on an underlying share by: (i) a financial institution in cases where a registered securities dealer that does not deal at arm's length with the financial institution enters into one or more hedging transactions that reduce the financial institution's economic exposure to the underlying share provided that the registered securities dealer knew (or ought to have known) that the transactions produced such reduction in exposure; or (ii) a registered securities dealer that holds the Canadian shares if it eliminates all or substantially all of its economic exposure to such shares by entering into certain hedging transactions.

Expanding the Scope of Interest Coupon Stripping Rules

Under the Tax Act, interest paid by a Canadian resident borrower to a non-resident lender is generally exempt from withholding tax provided that: (i) the interest is computed by reference to a fixed rate or a market standard floating rate; and (ii) the borrower and lender deal at arm's length. If either of these conditions is not satisfied, the Tax Act imposes a 25% withholding tax on the interest payments, although this rate is potentially reduced (usually to 10% or 15%) under an applicable income tax treaty. The Tax Act also contains a supporting rule designed to prevent interest coupon stripping transactions under which a non-arm's length, non-resident lender sells the interest coupons on the loan to a third party with which the Canadian resident borrower deals at arm's length. Budget 2022 expands the scope of these rules in order to capture transactions that, in general terms, involve the sale by a non-resident lender of the interest coupons in respect of a particular loan to either: (i) a resident of Canada; or (ii) a non-resident that would be able to benefit from a treaty reduced rate of withholding tax. If applicable, under this proposal, the Canadian borrower will be deemed to pay an amount of interest to the non-resident lender such that the withholding tax on the deemed interest payment equals the tax otherwise avoided as a result of the interest coupon stripping transaction.

Changes to the Flow-Through Share Rules

Elimination of the Flow-Through Share Regime for Oil, Gas, and Coal

Budget 2022 proposes to completely eliminate the flow-through share (FTS) regime for oil, gas and coal exploration and development, effective for FTS agreements entered into after March 31, 2023.

Introduction of Critical Mineral Exploration Tax Credit

Budget 2022 introduces a new Critical Mineral Exploration Tax Credit (CMETC) for flow-through shareholders of 30% of qualifying exploration expenses for specified minerals used in batteries and magnets for zero-emission vehicles and clean technology (e.g., copper, nickel, lithium, etc.). The CMETC is intended to apply to eligible expenditures renounced under FTS agreements dated after Budget Day and on or before March 31, 2027. The CMETC is separate from the existing Mineral Exploration Tax Credit (METC) of 15% for eligible mining exploration expenses, and expenditures cannot benefit from both the CMETC and METC.

Additional Support for Carbon Capture and Clean Technology

Introduction of a new Investment Tax Credit for Carbon Capture, Utilization and Storage

Budget 2022 introduces a new refundable Investment Tax Credit for Carbon Capture, Utilization and Storage (CCUS) to offset the cost of certain equipment in respect of qualifying CCUS projects that capture carbon dioxide in Canada, starting January 1, 2022. The credit will vary between 37.5% and 60% depending on the equipment type between 2021 and 2030, dropping to between 18.75% and 30% between 2030 and 2040.

Budget 2022 also introduces:

- two new capital cost allowance (CCA) classes applicable to qualifying CCUS equipment, one permitting an 8% CCA rate for certain capture, transportation, and storage equipment and the other permitting a 20% CCA rate for equipment required to store carbon dioxide in an eligible manner; and
- two CCA classes for intangible exploration expenses (at a 100% CCA rate) and development expenses (at a 30% CCA rate) associated with storing carbon dioxide.

Clean Technology Incentives

Budget 2022 contains certain clean technology incentives, including:

- the addition of accelerated Class 43.1 or 43.2 CCA depreciation for air-source heat pumps primarily used for non-building related space or water heating, and confirmation of the government's commitment to expand Class 43.1 and 43.2 CCA treatment to clean energy equipment first announced in the 2021 Federal Budget (see https://www.stikeman.com/en-ca/kh/guides/2021-Federal-Budget-Commentary); and
- a one-half federal corporate tax rate reduction for qualifying zero-emission technology manufacturers and processing, for tax years beginning after 2021 until 2029 (and then phased out by 2032).

Borrowing by Defined Benefit Pension Plans

Registered pension plans are restricted from borrowing money except in limited circumstances including where the term of the loan does not exceed 90 days and the property of the plan is not pledged as security for the loan. Budget 2022 proposes to replace for defined benefit plans this short term exception with a limit on the total amount of additional borrowed money (for purposes other than acquiring real property) equal to the lesser of: (i) 20% of the value of the plan's assets (net of unpaid borrowed amounts); and (ii) the amount, if any, by which 125% of the plan's actuarial liabilities exceeds the value of the plan's assets (net of unpaid borrowed amounts).

Surplus Stripping and Intergenerational Business Transfers

The Tax Act contains a rule which prevents converting dividends into capital gains through certain self-dealing transactions (commonly referred to as "surplus stripping"). Bill C-208 introduced an exception to this rule which intended to facilitate intergenerational business transfers.

Budget 2022 acknowledges that this exception could unintentionally permit surplus stripping without requiring a genuine intergenerational business transfer to have taken place and has announced a consultation process for Canadians to share views as to how the existing rules could be modified to protect the integrity of the tax system while continuing to facilitate genuine transfers.