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Highlights of Canada's 2022 federal budget

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On April 7, 2022 (Budget Day), Finance Minister Chrystia Freeland tabled her second budget in the House of Commons (Budget 2022).

What you need to know

- **Canada recovery dividend (CRD) and additional tax on banks and life insurers.** Budget 2022 proposes two additional taxes on bank and life insurer groups. The first is the CRD, which is a one-time 15% tax that will be imposed for the 2022 taxation year and payable in equal amounts over five years. The second is an additional 1.5% tax, that will generally apply to taxation years that end after Budget Day.
- **Hedging and short selling by Canadian financial institutions.** According to Budget 2022, Canadian banks engage in "aggressive tax planning arrangements" involving, on the one hand, a dividend received deduction claimed on a Canadian share owned by the bank, and on the other hand, the deduction of two-thirds of a dividend compensation payment by a related registered securities dealer on the short sale of an identical share. According to the government, this results in "an artificial tax deduction" that the government proposes to deny by way of specific legislation.
- **Substantive Canadian-controlled private corporations (CCPCs).** The refundable tax in Part I of the *Income Tax Act* (Tax Act) applicable to certain investment income earned by CCPCs (Part I refundable tax) will be extended to also apply to "substantive CCPCs", which are defined as Canadian-resident private corporations that: (i) are controlled, directly or indirectly in any manner whatever, by one or more Canadian-resident individuals; or (ii) would, if each share of a corporation that is owned by a Canadian-resident individual were owned by a particular individual, be controlled by the particular individual. This change will generally apply to taxation years ending on or after Budget Day, subject to a limited exception.

  Additional changes are also proposed to eliminate the tax-deferral advantage afforded a CCPC when it is a shareholder of a controlled non-resident corporation that earns certain passive income (referred to in the Tax Act as "foreign accrual property income" (FAPI)), effective for taxation years that end on or after Budget Day.
- **Application of the general anti-avoidance rule (GAAR) to tax attributes.** A 2018 Federal Court of Appeal decision held that the GAAR did not apply to a tax attribute that had not yet been used to reduce, avoid or defer tax. Budget 2022 proposes to override this decision so that the GAAR can apply to deny tax attributes that have not yet been used by taxpayers. This proposal will also impact obligations of taxpayers under the enhanced mandatory disclosure rules that the government published as draft legislation in February 2022. The new measure will apply to transactions that occur on or after Budget Day (subject to a limited exception).

- **International tax reform: Pillar One and Pillar Two.** Further to Canada's commitment to Pillar One (relating to the multilateral approach to reallocating taxing rights) and Pillar Two (relating to a global minimum tax) of the Inclusive Framework of the Organisation for Economic Co-Operation and Development (OECD) and the Group of 20 (G20) on base erosion and profit shifting (BEPS), in Budget 2022, the government indicated that:
  - it intends for the domestic digital services tax (DST) proposals released in December 2021 to apply only if an international multilateral convention implementing Pillar One is not in force by January 1, 2024; and
  - draft legislation implementing Pillar Two, and an associated domestic minimum top-up tax, will be released for consultation and come into effect sometime in 2023, and in the meantime, it is seeking submissions on Canada's implementation of the detailed model rules for Pillar Two released by the OECD/G20 Inclusive Framework (Model Rules), with submissions due by July 7, 2022.
- **Borrowing by defined benefit pension plans.** Budget 2022 expands the ability of registered pension plans to borrow money and permits them to borrow for general purposes and not merely to acquire real estate or for a short term. This measure will apply to amounts borrowed by registered pension plans (other than individual pension plans) on or after Budget Day.

Click below or use the in-page navigation menu for analysis on key measures included in Budget 2022.

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Business income tax measures

CRD and additional tax on banks and life insurers

Budget 2022 announced the introduction of the CRD, a one-time 15% tax applicable to bank and life insurer groups. A group for the purposes of the CRD will include a bank or life insurer and any other financial institution (for the purposes of Part VI of the Tax Act) that is related to the bank or life insurer.

The CRD will apply to a corporation's taxable income for taxation years ending in 2021 (a proration rule will apply for short taxation years). Bank and life insurer groups are permitted to allocate a $1 billion taxable income exemption from the CRD among group members. The tax liability for the CRD will be imposed in the 2022 taxation year and will be payable in equal amounts over five years.

Budget 2022 also proposes a new additional tax of 1.5% on the taxable income for members of bank and life insurer groups. The groups subject to this additional tax will be permitted to allocate a $100 million taxable income exemption among group members.

The new additional tax will apply to taxation years that end after Budget Day. For a taxation year that includes Budget Day, the new additional tax will be prorated based on the number of days in the taxation year after Budget Day.

No draft legislation has yet been released for the CRD or the new additional tax.

Hedging and short selling by Canadian financial institutions

Generally, the Tax Act allows Canadian corporations to deduct taxable dividends received on shares of other Canadian corporations. The Tax Act also allows registered securities dealers to deduct two-thirds of dividend compensation payments paid to lenders under securities lending arrangements (as an exception to the general rule whereby dividend compensation payments are not deductible).

According to the government, certain financial institutions are engaging in what the government refers to as "aggressive tax planning". Under such plans, a Canadian bank owns a Canadian share and claims a dividend received deduction. A related registered securities dealer borrows an identical share and sells it short, claiming a two-thirds deduction on dividend compensation payments made to the lender of the identical share. The government notes that such transactions could also be carried out by the registered securities dealer on its own. In such cases, the registered securities dealer owns the Canadian share and claims the dividend received deduction in addition to borrowing and selling short an identical share and deducting two-thirds of the dividend compensation payment.

According to the government, this results in an "artificial tax deduction" equal to two-thirds of the amount of the dividend compensation payment.

The government states that such arrangements could be challenged under existing rules of the Tax Act, but that such challenges could be time-consuming and costly. The government proposes to amend the Tax Act to deny a dividend received deduction where a taxpayer enters into a "specified hedging transaction", defined as:

- Where the taxpayer is not a registered securities dealer, a transaction entered into by a registered securities dealer that does not deal at arm's length with the taxpayer and that has the effect of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of certain shares owned by the taxpayer. In this case, the registered dealer must reasonably be considered to have entered into the transaction with the knowledge that, or ought to have known that, this result would occur.

- Where the taxpayer is a registered securities dealer, a transaction entered into by a registered securities dealer that has the effect of eliminating all or substantially all of the registered securities dealer's risk of loss and opportunity for gain or profit in respect of certain shares owned by the registered securities dealer.

The government also proposes to amend the Tax Act to allow a full (instead of two-thirds) deduction of the dividend compensation payment when a dividend received deduction is denied because the registered securities dealer entered into a specified hedging transaction.

The proposed legislation will apply to dividends and dividend compensation payments that are paid, or become payable, on or after Budget Day. However, if the relevant hedging transactions or securities lending arrangements were in place before Budget Day, the proposed legislation will apply to dividends and related dividend compensation payments that are paid after September 2022.

Substantive CCPCs

Budget 2022 introduces new rules to limit the ability of certain Canadian-resident private corporations to avoid CCPC status. Although CCPCs are entitled to a preferential tax rate on active business income, they are also subject to refundable taxes on certain types of investment income that other private "non-CCPCs" are not.

When combined with the non-refundable portion of the tax on investment income of a CCPC, this refundable tax is intended to approximate the top marginal personal income tax rate, minimizing any tax deferral opportunity for Canadian-resident individuals to earn investment income in a CCPC, as opposed to directly. This tax is refunded as the CCPC pays out certain taxable dividends. The changes to the Tax Act proposed in Budget 2022 will only impact Part I refundable tax, which is payable in respect of certain types of investment income, such as taxable capital gains, interest, rent and FAPI, and not the 38 1/3% refundable tax payable under Part IV of the Tax Act with respect to certain taxable dividends.

CCPC status

As outlined in Budget 2022, the government is concerned that taxpayers are inappropriately "manipulating" CCPC status to achieve a tax-deferral advantage on such investment income earned in their corporations. This might be done, for example, by continuing a corporation under foreign law, by interposing a non-resident corporation into a corporate structure or by issuing options to a non-resident. Each of these techniques would cause the corporation to no longer meet the technical requirements to be a CCPC under the current rules in the Tax Act and to no longer be subject to the Part I refundable tax regime on such investment income. Accordingly, such investment income (other than taxable dividends) earned by the corporation would be subject to tax at ordinary corporate tax rates (approximately half the top marginal income tax rate for individuals). This planning may have been tax-efficient for CCPCs (or corporations that would have been CCPCs but for this planning) which had a meaningful amount of investment income or which did not rely on other beneficial tax treatments for CCPCs.

Budget 2022 proposes to introduce a “substantive CCPC” concept to address this perceived abuse. A substantive CCPC will be defined as a private corporation (other than a CCPC) that:

- is controlled, directly or indirectly in any manner whatever, by one or more Canadian-resident individuals; or
- would, if each share of the capital stock of a corporation that is owned by a Canadian resident individual were owned by a particular individual, be controlled by the particular individual.

According to the government, introducing this concept will address tax planning that manipulates CCPC status without affecting “genuine non-CCPCs”, such as private corporations that are ultimately controlled by non-resident persons and subsidiaries of public corporations. Budget 2022 indicates that this measure will cause a corporation to be a substantive CCPC in situations where the corporation would have been a CCPC but for the fact that a non-resident person or a public corporation has a right to acquire its shares.

In Budget 2022, the Government states that substantive CCPCs will be subject to the same tax consequences as if they were CCPCs subject to Part I refundable tax on their investment income, such that certain investment income of a substantive CCPC will be subject to tax at an overall federal rate of 38 2/3%, of which 30 2/3% would be refunded once sufficient non-eligible dividends had been paid. Substantive CCPCs will be treated as non-CCPCs for all other purposes of the Tax Act.

In support of the foregoing rules, Budget 2022 proposes to introduce an anti-avoidance rule that will deem a corporation resident in Canada (other than a CCPC) to be a substantive CCPC if it is reasonable to consider that one of the purposes of any transaction (as defined in subsection 245(1) of the Tax Act to include an arrangement or event) or series of transactions was to cause the corporation not to qualify as a substantive CCPC. The government is also proposing certain “targeted amendments” to facilitate administration of these new rules, including a one-year extension on the normal reassessment period for tax that arises from a corporation being assessed or reassessed a dividend refund.

These measures will apply to taxation years ending on or after Budget Day, although the government is proposing to include relief for year-ends that occur as a result of certain arm’s length share sales pursuant to purchase and sale agreements which were entered into before Budget Day and which close before 2023.

FAPI rules

The FAPI rules are intended to prevent Canadian-resident taxpayers from deferring tax on FAPI earned through a controlled non-resident corporation (referred to in the Tax Act as a “controlled foreign affiliate” (CFA)). The FAPI rules do this by taxing the Canadian shareholder on their share of the CFA’s income, on an accrual basis and at the same level as if the shareholder earned the income directly. Where the Canadian shareholder is a CCPC, this FAPI is included in the CCPC’s investment income and is subject to the Part I refundable tax regime described in the preceding section.

To prevent double taxation of the investment income, the FAPI rules include complex mechanisms to take into account income tax charged to the CFA by a foreign jurisdiction. Generally, an effective tax rate of at least 25% in that foreign jurisdiction would result in a Canadian corporate shareholder not having to pay tax on FAPI earned in the CFA. For Canadian individual shareholders, the effective tax rate in the foreign jurisdiction would have to be at least 52.63% before they would not be subject to tax in Canada.

However, these rules do not distinguish between CCPCs and non-CCPCs. As a result, a CCPC may not have to pay Canadian tax on investment income earned in a CFA when the CFA pays foreign tax at a rate of at least 25%. As noted previously, the CCPC rules are intended to minimize the deferral benefit of earning investment income in a CCPC, and accordingly, the government is of the view that this is an inappropriate result.

Budget 2022 proposes changes to the FAPI regime so that a CCPC (and a substantive CCPC) will generally be taxed on investment income earned in a CFA in the same manner as an individual: that is, the CFA would have to pay foreign tax on investment income at a rate of at least 52.63% before the CCPC/substantive CCPC would not be subject to Canadian tax on that income.

Budget 2022 also proposes new rules intended to prevent investment income subject to a tax rate of at least 52.63% in the CFA's jurisdiction of residence from being subject to excessive additional tax when it is repatriated to Canada and eventually paid to individual shareholders. Generally, these rules will operate by reducing the CCPC/substantive CCPC's general rate income pool by certain deductions claimed on account of the foreign taxes and adding certain amounts to the CCPC/substantive CCPC's capital dividend account (which amounts may generally be distributed to Canadian-resident shareholders on a tax-free basis) to ensure some level of FAPI integration. Accordingly, if a CFA pays foreign tax on its investment income at rate of at least 52.63%, there should not be any additional tax when the after-tax amount of that income is repatriated to the CCPC/substantive CCPC or to ultimate individual shareholders of the CCPC/substantive CCPC.

These changes will generally apply to taxation years that begin on or after Budget Day.

Small business deduction

To facilitate small business growth, Budget 2022 proposes to expand eligibility for the small business deduction available to CCPCs.

In previous years, the small business deduction enabled CCPCs to enjoy a 9% corporate income tax rate (as opposed to the 15% general corporate tax rate) on a business limit of $500,000 per year of "qualifying active business income". This $500,000 business limit was gradually reduced to zero, on a straight-line basis, when a CCPC (in combination with any associated corporations) had either:

- between $10 million and $15 million of taxable capital employed in Canada; or
- between $50,000 and $150,000 in "adjusted aggregate investment income".

The relatively small range of $10 million to $15 million of taxable capital meant that there would be a rapid reduction of the $500,000 business limit once a CCPC exceeded the $10 million threshold. Budget 2022 proposes to increase the upper limit of the taxable capital range to $50 million. This increase will make the reduction of the business limit more gradual for CCPCs that were already able to take advantage of the deduction, and will provide many medium-sized CCPCs with access to some level of the small business deduction, where previously it was fully unavailable.

This proposed amendment will apply to taxation years that begin on or after Budget Day.

Investment tax credit for carbon capture, utilization and storage

In line with the government's environmental commitments and interest in encouraging investment in clean energy initiatives, Budget 2022 proposes a new refundable investment tax credit (CCUSTC) for eligible carbon capture, utilization, and storage (CCUS) projects.

The CCUSTC will be a refundable credit available from January 1, 2022 through to 2040, for expenses incurred to acquire or install eligible equipment used in eligible CCUS projects, so long as the equipment was part of a project where the captured carbon dioxide (CO2) was used for an eligible use.

CCUSTC rates

Depending on which eligible equipment is utilized in a CCUS project, and when the expense is incurred, different credit rates will apply for purposes of the CCUSTC:

- a 60% rate for eligible capture equipment used in a direct air capture project (30% from 2031-2040);
- a 50% rate for all other eligible capture equipment (25% from 2031-2040); and

- a 37.5% rate for eligible transportation, storage, and use equipment (18.75% from 2031-2040)

The CCUSTC can be claimed on eligible expenses in the taxation year that the expense is incurred, regardless of when the equipment becomes available for use.

Eligible projects

Eligible CCUS projects are new projects that:

- capture CO2 directly from the air, or capture CO2 that would otherwise be released into the atmosphere;
- prepare captured CO2 for compression;
- compress and transport captured CO2; or
- store or use captured CO2.

Equipment will only be considered eligible if the CO2 is captured in Canada, although CO2 may be stored or used outside Canada provided that the project satisfies all other requirements. Certain CCUS projects that may otherwise apply will not be eligible where emissions reductions are necessary to achieve compliance with emissions regulations.

Eligible equipment and new capital cost allowance (CCA) classes

Eligible equipment is equipment used solely to capture, transport, store, or use CO2 as part of an eligible CCUS project. The CCUSTC will not be available for equipment in respect of which a previous owner has received the CCUSTC, although this may be practically difficult for taxpayers to verify and may require representations from sellers where purchasers intend to apply for the CCUSTC in respect of purchased equipment.

CCUS equipment will also be included in one of two new CCA classes proposed by Budget 2022, and eligible for enhanced first-year depreciation under the accelerated investment incentive, which allows investors to write off a larger share of the costs of newly acquired capital assets in the year the investment is made or the year the asset becomes available for use.

The new proposed CCA classes include:

- an 8% CCA rate on a declining-balance basis for:
  - capture equipment used solely to capture CO2;
  - transportation equipment, such as pipelines or dedicated vehicles, used for transporting CO2; and
  - CO2 injection and storage equipment;
- a 20% CCA rate on a declining-balance basis for use equipment required for using CO2 in an eligible use.

These CCA classes will include the cost of converting existing equipment for use in a CCUS project, equipment used for monitoring and tracking CO2, and buildings or other structures that solely support a CCUS project.

Certain equipment, such as equipment required for hydrogen production, natural gas processing, or acid gas injection or that does not support CCUS, will be ineligible.

Exploration and development expenses related to storing CO2, while not eligible for the CCUSTC, will be included in two other new proposed CCA classes with CCA rates of 100% (for intangible exploration expenses) and 30% (for development expenses), on a declining-balance basis.

Eligible CO2 uses

Importantly, the end use of the CO2 captured through an eligible CCUS project will be considered to determine the availability of the CCUSTC. Eligible uses will include storage of CO2 in dedicated geological sites and storage of CO2 in concrete, both of which are subject to approval by Environment and Climate Change Canada. Initially, the CCUSTC will only be available to CCUS projects that store the CO2 in Saskatchewan or Alberta.

Taxpayers will need to track the use of CO2 carefully. Where captured CO2 from an eligible CCUS project is used for both eligible and ineligible uses, the CCUSTC will be reduced by the portion of CO2 that is expected to go to ineligible uses, as set out in the initial project plans.

Budget 2022 outlines the recovery of CCUSTCs where CO2 is found to go to an ineligible use. Although specific design features will be released at a later date, the CCUSTC may be recovered if the portion of CO2 going to an ineligible use is more than five percentage points higher than set out in the initial project plans. The use of CO2 will be assessed at five-year intervals, to a maximum of 20 years, to determine if a recovery of the CCUSTC is warranted.

Compliance: validation and verification

To be eligible for the CCUSTC, taxpayers will be required to produce a climate-related financial disclosure report indicating how their corporate governance, strategies, policies and practices will help manage climate-related risks and opportunities, as well as how they will contribute to achieving Canada's commitment to a goal of net zero by 2050 under the Paris Agreement.

Further, projects with eligible expenses expected to be $100 million or greater will be required to undergo an initial project tax assessment, based on initial project design, to identify what expenses are eligible for the CCUSTC. Project proponents with expected eligible expenses below $100 million can also voluntarily undergo a project tax assessment.

Before CCUSTCs can be claimed, eligible expenses will have to be verified by Natural Resources Canada.

Clean technology tax incentives – air source heat pumps

CCA for clean energy equipment

Budget 2022 proposes to expand CCA classes 43.1 and 43.2, which provide accelerated CCA rates (30% and 50%, respectively) for investments in specified clean energy generation and energy conservation equipment. Classes 43.1 and 43.2 will be expanded to include air-source heat pumps primarily used for space or water heating and will apply in respect of property that is acquired and that becomes available for use on or after Budget Day, where it has not been used or acquired for use for any purpose before Budget Day.

Eligible property will include equipment that is part of an air-source heat pump system, such as refrigerant piping, energy conversion equipment, thermal energy storage equipment, control equipment and equipment designed to a system to interface with other heating and cooling equipment.

The expansion of classes 43.1 and 43.2 will not apply to buildings, energy equipment that backs up an air-source heat pump system, or equipment that distributes heated or cooled air or water within a building.

Rate reduction for zero-emission technology manufacturers

The 2021 federal budget (Budget 2021) had proposed a temporary reduction of corporate tax rates for qualifying zero-emission technology manufacturers that include:

- a 7.5% rate, where the income would have otherwise been taxed at a 15% general corporate tax rate; and
- a 4.5% rate, where the income would have otherwise been taxed at the 9% small business rate.

These reduced tax rates will be phased out starting in 2029, and fully phased out in 2032.

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.

Critical mineral exploration tax credit (CMETC)

To augment the existing mineral exploration tax credit (METC) regime, Budget 2022 proposes a new 30% CMETC for individuals who invest in mining flow-through shares for projects that mine specified critical minerals (copper, nickel, lithium, cobalt, graphite, rare earth elements, scandium, titanium, gallium, vanadium, tellurium, magnesium, zinc, platinum group metals and uranium), which are used in the production of zero-emissions vehicles, batteries, and other clean technologies.

The administration of the CMETC will generally follow the rules in place for the METC, and eligible expenditures will not benefit from both the proposed CMETC and the existing METC.

The CMETC will apply to flow-through share agreements entered after Budget Day until March 31, 2027.

Flow-through shares for oil, gas and coal activities

While bolstering the flow-through share regime for critical mineral exploration, Budget 2022 also proposes to eliminate the flow-through share regime for oil, gas, and coal activities—a change that will apply to expenditures renounced under flow-through share agreements entered into after March 31, 2023.

Application of the GAAR to tax attributes

The GAAR in section 245 of the Tax Act applies to disallow tax benefits obtained through abusive tax avoidance.

The government announced a comprehensive review of the GAAR in 2020[1], and Budget 2022 proposes to continue with that review. While the review is ongoing, Budget 2022 proposes to legislatively overrule recent court decisions interpreting the "tax benefit" definition. In 2018, the Federal Court of Appeal held in *1245959 Alberta Ltd.* that the mere creation of a tax attribute does not constitute a "tax benefit" for purposes of the GAAR[2]. A tax benefit only exists when an attribute is used to reduce, avoid or defer tax. Subsequent case law has followed this reasoning[3]. The interpretation was consistent with the general principle that a tax dispute may only proceed where the taxpayer disagrees with the amount of tax payable for a taxation year.

Budget 2022 proposes to amend the definition of "tax benefit" and "tax consequences" to essentially include tax attributes that may, in future, be used to reduce, avoid or defer tax even if those attributes have not yet been used and may expire prior to use.

The expanded scopes of the definitions of "tax benefit" and "tax consequences" will have resounding implications for the enhanced mandatory disclosure rules that the government published as draft legislation in February 2022[4]. The expansions to these definitions will mean that more tax transactions fall under the mandatory disclosure rules, increasing the amount of paperwork (and corresponding compliance costs) incurred due to these rules.

Budget 2022 proposes that the Minister of National Revenue (Minister) issue a notice of determination where she determines the tax consequences to a taxpayer because of the GAAR with respect to a transaction. A notice of determination generally gives rise to the same dispute rights as a notice of assessment. This procedural expansion means that the Minister, upon receipt of a mandatory disclosure report, could forthwith issue a notice of determination in respect of expected tax benefits. This approach may significantly accelerate the start of the tax dispute process compared with the ordinary audit process.

These amendments will apply to transactions that occur on or after Budget Day, and to transactions that occur before Budget Day if the Canada Revenue Agency (CRA) issues a GAAR determination on or after Budget Day in respect of the transaction. Budget 2022 clarifies that the amendments will not apply to GAAR determinations in which all rights of objection and appeal were exhausted before Budget Day.

International tax measures

International tax reform: Pillar One and Pillar Two

Budget 2022 aligns Canada to implement international tax reforms around two pillars. The reforms aim to address tax challenges caused by the digitization of economies.

Pillar One is intended to ensure that the largest and most profitable multinational enterprises (MNEs) pay a fair share of tax in the countries where their users and customers are located. It will reallocate taxing rights over MNEs that conduct significant value-generating activities in jurisdictions in which it they do not have traditional physical business presence.

Pillar Two is intended to impose a global minimum tax on large MNEs. It aims to end a "race to the bottom" among nations in international corporate taxation by setting a floor on tax competition, while leaving flexibility for governments to design their income tax systems to support business investment and innovation.

On October 8, 2021, Canada, together with 137 members of the OECD/G20 Inclusive Framework on BEPS, endorsed the two-pillar plan for international tax reform. The group released Model Rules for Pillar Two on December 20, 2021 and a commentary on the Model Rules on March 14, 2022. The group aims to release an Implementation Framework for Pillar Two—including filing obligations and multilateral review processes—by the end of 2022.

Budget 2022: 1) outlines the intended timeline for Canada's implementation of both Pillar One and Pillar Two; 2) confirms that the government intends its proposed domestic DST, described in Budget 2021 with draft legislative proposals released in December 2021, to apply only if and while an international multilateral convention implementing Pillar One is delayed; and 3) launches a public consultation on Canada's implementation of the Model Rules for Pillar Two with submissions due by July 7, 2022.

Pillar One – reallocation of taxing rights over certain MNEs

Canada is working with its international partners to develop the model rules and the multilateral convention needed to establish the new multilateral allocation framework under Pillar One and bring it into effect. Budget 2022 states an intention to introduce Canadian implementing legislation after the terms are agreed on multilaterally.

Pillar One provides a new tax allocation framework for MNEs with global revenues above €20 billion and a profit margin (profit before tax as a share of revenue) above 10%. Certain resource extraction and regulated financial services enterprises will be excluded. Where Pillar One applies, 25% of residual profit (profit over 10% of revenue) will be allocated to jurisdictions using a revenue-based allocation key. That key has yet to be agreed upon. To avoid double taxation, tax relief will be provided by the jurisdictions where re-allocated amounts will normally be taxed under traditional rules. Pillar One will provide for a mandatory and binding dispute prevention and resolution mechanism to help coordinate taxation among participating countries.

As a backup plan, Budget 2022 proposes that the previously announced DST, which would impose a 3% tax on revenue earned by large businesses from certain digital services that rely on data or content from Canadian users, may apply as of January 1, 2024 (in respect of revenues earned as of January 1, 2022) if a multilateral convention implementing Pillar One has not come into force by that time. The DST would apply until a multilateral convention on Pillar One comes into force. The government is currently reviewing feedback received on its legislative proposals for the DST.

Pillar Two – global minimum tax for certain MNEs

Budget 2022 indicates that draft legislation implementing Pillar Two and an associated domestic minimum top-up tax applying to Canadian entities of in-scope MNEs will be released for consultation and come into effect sometime in 2023. An undertaxed profits rule (UTPR) component of Pillar Two, described below, will come into effect no earlier than 2024.

In the meantime, the government is seeking submissions as part of a public consultation on the implementation in Canada of the Model Rules for Pillar Two open until July 7, 2022. The government describes the principal purpose of the public consultation as understanding the interaction between the Model Rules and the Canadian legal and income tax context, rather than seeking views on major design aspects of the Model Rules or broader policy implications. The government indicates that it is committed to the multilateral process that developed the Model Rules and notes that failure to implement the common approach set out in the Model Rules risks leaving MNEs based in Canada open to additional taxation in other jurisdictions without Canada receiving any of that tax[5].

Budget 2022 notes that Canada's timelines for domestic implementation of Pillar Two are advocated by the OECD/G20 Inclusive Framework on BEPS and in line with international developments related to Pillar Two. Members of the European Union are currently debating a draft directive that, if adopted, would require member states to implement Pillar Two into national laws effective 2023. The United Kingdom anticipates implementing measures associated with Pillar Two in April 2023 and April 2024. Legislative proposals in the United States aim to bring the existing United States global intangible low-taxed income (GILTI) regime into closer alignment with Pillar Two. In the meantime, the OECD/G20 Inclusive Framework on BEPS is considering how GILTI can co-exist with Pillar Two.

Outline of how Pillar Two would work

Pillar Two seeks to impose a global minimum tax of 15% that reduces incentives for MNEs to shift profits to low-tax jurisdictions and that incentivizes countries not to reduce international corporate taxation below a 15% floor. It would apply to MNEs with annual revenues of €750 million or more.

Pillar Two works through three basic elements: 1) an income inclusion rule (IIR); 2) an UTPR; and 3) a mechanism for qualifying domestic minimum top-up taxes.

The IIR

If the jurisdiction in which the ultimate parent entity of an in-scope MNE is located has implemented the IIR, that jurisdiction will have the primary right to impose a top-up tax on the ultimate parent entity with respect to income from the MNE's operations in any jurisdiction where it is taxed at an "effective tax rate" below 15%. If the ultimate parent jurisdiction has not implemented the IIR, this right to impose a top-up tax shifts to the jurisdiction of the highest-tier intermediate parent entity within the MNE's structure that has adopted the IIR. More complicated rules address situations in which some entities within an MNE's structure have a certain percentage of independent owners that are not part of the MNE's group. The Model Rules include rules for determining the revenue and "effective tax rate" of MNEs for the purpose of imposing the top-up tax.

The UTPR

The UTPR is meant to be a "backstop rule" where no ultimate or intermediate parent of an in-scope MNE is in a jurisdiction that has implemented an IIR. In that case, other jurisdictions in which the MNE operates may impose a top-up tax on income taxed at an "effective tax rate" below 15%, on the group entities in those jurisdictions (i.e., tax under the UTPR). The tax will be allocated among relevant jurisdictions based on a formula.

The UTPR is meant to incentivize countries to adopt the IIR by: 1) ensuring that a minimum 15% tax will apply even where an in-scope MNE's parent companies are located in non-implementing jurisdictions; and 2) disallowing countries with IIRs that do not conform to the Model Rules from participating in the Pillar Two UTPR mechanism.

Qualifying domestic minimum top-up taxes

The Pillar Two Model Rules also contemplate that jurisdictions may enact a domestic minimum top-up tax on low-taxed income of domestic entities. If this domestic top-up tax is designed to achieve the intended outcomes of Pillar Two, it is considered a "qualified" top-up tax under Pillar Two and is creditable dollar-for-dollar against any top-up tax liability otherwise arising under Pillar Two. This allows a jurisdiction to collect the top-up tax applicable to low-taxed income of its domestic entities rather than allowing the top-up tax to accrue to other jurisdictions under the IIR or UTPR.

Subject-to-tax rule

Finally, the Pillar Two Model Rules also contain a "subject-to-tax rule" allowing a developing county to request changes to a bilateral treaty to increase withholding tax on certain payments where the partner country has a nominal tax rate below 9% applying to any of the types of payments covered. Budget 2022 indicates that the government does not expect this rule, as currently proposed, to impact Canada.

Exchange of tax information on digital economy platform sellers

Budget 2022 proposes to introduce further rules to support the initiatives to tax the digital economy carried on through digital platforms (apps for services, including short-term rentals, ride sharing and shopping). The proposals are aimed at certain digital platform operators, making them subject to reporting consistent with the enhanced tax reporting model OECD rules being used internationally.

The model OECD rules were developed to combat non-compliance concerns by international tax authorities that transactions occurring digitally through online platforms may not always be visible to tax authorities or self-reported by taxpayers. The rules require certain digital platform operators to collect and report information to relevant tax authorities.

Canada's version would require "reportable platform operators" that provide support to "reportable sellers" for "relevant activities" to identify the jurisdiction of residence of their reportable sellers (though due diligence procedures) and to report certain information on them to the CRA. They will apply to Canadian resident platform operators, as well as non-Canadian resident platform operators that facilitate relevant activities by Canadian resident sellers or with respect to rental of immovable property located in Canada. Reportable sellers and relevant activities would generally include active platform users offering accommodation, transport and personal services, as well as those selling goods, through the platforms.

There are exceptions. Platform operators would not include: 1) software that exclusively facilitates the processing of compensation, the mere listing or advertising of relevant activities or the transfer of users to another platform; 2) platform operators that facilitate activities for which total compensation in the prior year is less than €1 million and elect to be excluded; and 3) platform operators that demonstrate that their sellers do not profit from compensation received or that have no reportable sellers. Additionally, platform operators would not be required to report on governmental entities, entities whose stock is regularly traded on an established securities market, certain large providers of hotel accommodations, and certain entities selling goods with fewer than 30 sales a year for a total of less than €2,000.

Reporting platform operators would be required to report to the CRA specified information by January 31 of the year following the calendar year for which a seller is identified as a reportable seller.

The CRA would share the reported information with jurisdictions that have implemented similar reporting requirements and have agreed to exchange information with the CRA, based on the residence of the relevant seller earning revenue through the platform or in the jurisdiction where the rental property is located. Currently, the European Union, the United Kingdom and Australia have announced their intention to implement the model OECD rules or a similar framework.

These measures are intended to apply to calendar years that begin after 2023. As such, the deadline for the first reporting and exchange of information would be January 31, 2025.

Interest coupon stripping

The current provisions of the Tax Act generally impose withholding tax at a rate of 25% on interest paid or credited by a Canadian resident borrower to a non-arm's length non-resident lender, subject to a reduction in the rate of withholding tax if the interest is paid to a resident in a country with which Canada has a tax treaty. Certain taxpayers have sought to avoid or reduce the application of withholding tax on interest using "interest coupon stripping arrangements", whereby a non-resident lender sells its right to receive future interest payments (i.e., interest coupons) in respect of a loan made to a non-arm's length Canadian-resident borrower to a party that is not subject to withholding tax, or would be subject to a lower rate of withholding tax than would apply to a payment of interest directly to the non-resident lender.

The Tax Act already contains rules which provide that where a non-resident lender makes an interest-bearing loan to a non-arm's length Canadian resident and sells the interest coupons to a non-resident person that deals at arm's length with the payer, the interest payment would remain subject to withholding tax because the interest is in respect of a debt owing to a person with whom the payer is not dealing at arm's length. However, other interest coupon stripping arrangements exist that are not caught by the existing rules. Budget 2022 proposes to expand the scope of the Tax Act to address further variations of interest coupon stripping arrangements not caught by existing rules.

Specifically, Budget 2022 proposes to codify the circumstances in which an interest coupon stripping arrangement will be considered to exist and address such arrangements with a new anti-avoidance rule. In general terms, an interest coupon stripping arrangement will be considered to exist where the following conditions are met:

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

Where an interest coupon stripping arrangement exists, the Canadian-resident borrower will be deemed, for the purposes of the interest withholding tax rules, 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 arrangement. Budget 2022 includes a proposed exception for interest paid on debts issued as part of an offering lawfully distributed to the public if, in general terms, none of the main purposes of the transaction is to reduce or avoid withholding tax otherwise payable on the interest payments by a non-resident taxpayer to whom the debt or other obligation is owed.

The proposed rules will apply to a Canadian-resident borrower in respect of interest that is paid or payable to an interest coupon holder to the extent that such interest accrued on or after Budget Day. However, this is subject to an exception if: 1) the interest payment is in respect of a debt or other obligation incurred by the Canadian-resident borrower before Budget Day; and 2) it is made to an interest coupon holder that deals at arm's length with the non-resident lender and that acquired the interest coupon as a consequence of an agreement or other arrangement entered into by the interest coupon holder, and evidenced in writing, before Budget Day. Where this exception applies, the proposed rules will apply to the extent that such interest accrued on or after the date that is one year after Budget Day (in other words, interest that accrues after April 7, 2023).

Personal income tax measures

Borrowing by defined benefit pension plans

Budget 2022 contains an important change regarding borrowings by registered pension plans. Specifically, Budget 2022 expands the ability of registered pension plans to borrow money and permits them to borrow for general purposes and not merely to acquire real estate or for a short term. This measure will apply to amounts borrowed by registered pension plans (other than individual pension plans) on or after Budget Day.

A pension plan is required to meet certain prescribed conditions in order to maintain its status as a registered pension plan exempt from tax under the Tax Act. If the prescribed conditions are not met, the plan can become what is called a "revocable plan"—a plan where the Minister can send a notice of intent to revoke the registration of the plan.

One of the prescribed conditions to avoid becoming a revocable plan is the borrowing condition. That condition provides that a trustee who holds property on behalf of the plan cannot borrow money except for the purpose of acquiring income-producing real property (which is either unsecured or secured only by the real property) and except for short-term (90 days or less) unsecured borrowings.

On July 2, 2020, as part of the government's Covid-19 response, the government temporarily relaxed the borrowing restrictions for registered pension plans. The government introduced the relaxation "[i]n response to the potential liquidity challenges faced by pension plans as a result of the COVID-19 pandemic". The relief was to eliminate the 90-day limit for loans repaid no later than April 30, 2021. This relief was subsequently renewed for loans repaid before April 30, 2022.

Budget 2022 proposes to leave in place the existing limitation for the money purchase provision of a registered plan or an individual pension plan. For defined benefit plans, however, Budget 2022 proposes to continue to permit borrowing to acquire real property which is either unsecured or secured only by the real property. The main change, however, is to permit defined benefit plans to borrow for any duration and for any purpose subject to a cap equal to the lesser of: 1) 20% of the value of the net plan assets; and 2) the amount by which 125% of the plan's actuarial liabilities exceeds the value of the net plan assets.

While there is a lack of clarity regarding the policy basis of the borrowing restriction, the relaxation of the restriction has a good policy basis under two of the main theories of the rule. To the extent that the policy of the borrowing restriction is to limit the total assets under management in the plan and to avoid the circumvention of the contribution limits through borrowing, this would be a less pressing concern in the context of a defined benefit pension, since greater assets would result in reduced employer contributions. To the extent that the policy of the restriction relates to the "riskiness" of borrowing, the rules contain limits on the overall amount of borrowing. These limits are supplemented by non-tax regulatory limits on borrowing that will continue to apply. Budget 2022 states:

> Plan administrators must continue to comply with the provisions of federal or provincial pension benefit standards legislation which ensure that pension funds are administered with a duty of care, investments are made in a reasonable and prudent manner and the plan is funded in accordance with prescribed funding standards. These standards are designed to manage the risks to the promised benefits of plan members and ensure the stability of registered pension plans. They would be unaffected by the proposed measure.

Borrowing restrictions continue to be applicable to tax-exempt investment, resource and real estate subsidiaries of pension funds. Unless those restrictions are updated to reflect the borrowing changes at the top of the plan, pension funds will need to continue to monitor to ensure that these entities avoid any prohibited borrowings.

Minimum tax for high earners

In Budget 2022, the government announced that it is committed to examining a new minimum tax regime in an effort to increase the fairness of the tax system.

In Budget 2022, the government notes that the existing alternative minimum tax regime plays a role in ensuring that the wealthiest Canadians do not take advantage of the tax system to lower their federal tax bill. These rules have been in place since 1986 but have not been substantially amended since their introduction.

The government is concerned that, despite the current alternative minimum tax rules, thousands of wealthy Canadians continue to pay little or no personal income tax each year. In this regard, Budget 2022 indicates that 28% of income tax filers with a gross income above $400,000 pay an average federal income tax rate of 15% or less.

Budget 2022 does not contain specific legislative amendments to implement a new minimum tax regime, but the government has committed to releasing additional details in the 2022 Fall Economic Update.

Tax administration measures

Since the 2016 federal budget, the government has increased funding for the CRA by approximately $2.2 billion with the goal of improving tax compliance, preventing tax evasion and enhancing tax collection efforts.

Budget 2022 builds on past measures by proposing to provide an additional $1.2 billion in funding over the next five years to the CRA. The objectives of the additional funding are to:

- expand audits of larger entities and non-residents engaged in aggressive tax planning;
- increase the investigation and prosecution of those engaged in criminal tax evasion; and
- expand the CRA's educational outreach.

The government expects to recover $3.4 billion in revenue from these additional investments in the CRA.

The implication of the significant funding increases is more audit activity, particularly for large corporate taxpayers with non-resident affiliates.

Goods and services tax/harmonized sales tax (GST/HST) measures

Health care rebate

The GST/HST rules permit eligible charities and non-profit organizations that provide health care services similar to those provided by hospitals to claim a rebate of 83% of the GST/HST they pay on inputs relating to their exempt supplies.

Under the current rules, the rebate is available for GST/HST incurred by eligible charities or non-profit organizations on inputs relating to health care services provided under the active direction of, or with the active involvement of, a physician, or, where the health care service is provided in a geographically remote area, a nurse practitioner.

In recognition of the increasing role of nurse practitioners in the delivery of health care services, including in non-remote areas, Budget 2022 proposes to eliminate the geographical restriction for health care services provided under the active direction of, or with the active involvement of, nurse practitioners. As a result of this amendment, the rebate for eligible charities and non-profit organizations will no longer distinguish between health care services delivered under the supervision of physicians and nurse practitioners.

This proposal will generally apply to claim periods ending after Budget Day in respect of GST/HST paid or payable after that date.

Assignment sales of residential housing by individuals

Under the current GST/HST rules, the sale by an individual (assignor) to another person (assignee) of the assignor’s rights under a new home purchase agreement with a builder (an assignment sale) may be taxable or exempt, depending on the assignor’s original intent in entering into the new home purchase agreement. An assignment sale would generally be taxable if the assignor had entered into the new home purchase agreement for the primary purpose of selling their interest in the agreement. On the other hand, an assignment sale would generally be exempt if the assignor had entered into the new home purchase agreement for the primary purpose of occupying the home as a place of residence.

Budget 2022 proposes to amend the GST/HST rules so that all assignment sales by individuals will be taxable for GST/HST purposes. In order to relieve double tax, it is proposed that the amount of the consideration for the assignment sale that is attributable to a deposit that the assignor previously paid to the builder will be excluded from the consideration for the assignment sale. Double tax could otherwise arise because the amount of the deposit would already be subject to GST/HST when applied by the builder to the purchase price of the new home.

This proposal will apply in respect of assignment sale agreements entered into on or after the day that is one month after Budget Day.

Status of outstanding income tax measures

In Budget 2022, the government confirmed its intention to proceed with a number of proposals that were previously announced, as modified to take into account consultations and deliberations since their release, including in particular:

- legislative proposals released on February 4, 2022 in respect of the following measures:
  - immediate expensing of eligible property acquired by a CCPC;
  - 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; and
  - interest deductibility limits;
- the income tax measure announced in Budget 2021 with respect to hybrid mismatch arrangements and the transfer pricing consultation; and
- the anti-avoidance rules (including the GAAR) consultation announced on November 30, 2020 in the fall economic statement[6].

FOOTNOTES

1. See *Supporting Canadians and Fighting COVID-19: Fall Economic Statement 2020*, released by the Department of Finance on November 30, 2020.
2. 1245959 Alberta Ltd. v. Canada (Attorney General), 2018 FCA 114.
3. For example, see *Gladwin Realty Corporation v. The Queen*, 2020 FCA 142, and *Rogers Enterprises (2015) Inc. v. The Queen*, 2020 TCC 92.
4. For more information regarding the mandatory disclosure rules, see our prior bulletin "Highlights of draft tax legislation to implement certain Budget 2021 measures".
5. Budget 2022 sets out general and general specific questions to guide submissions which are available in Budget 2022 Tax Measures: Supplementary Information, International Tax Measures under the heading "Consultation on Pillar Two".
6. Supra, note 1.

To discuss these issues, please contact the author(s).