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# 2022 Federal Budget — Spotlight on Financial Services

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Companies in the financial services industry may be affected by new measures in the 2022 federal budget. In particular, the budget introduces several changes that may have an important effect on financial institutions, including banks and insurance companies, such as:

- Canada Recovery Dividend and additional tax on banks and life insurers
- Hedging and short selling by Canadian financial institutions
- International Financial Reporting Standards for Insurance Contracts (IFRS 17)
- Pillar Two — Global Minimum Tax
- Reporting requirements for RRSPs and RRIFs.

In addition, asset management companies may want to review the following new 2022 federal budget measures to determine how they are affected:

- Housing & real estate investment trusts
- Green innovations & incentives
- Critical Mineral Exploration Tax Credit
- Eliminating flow-through shares for oil, gas and coal activities.

In addition to these measures, affected companies should also be aware of other previously announced measures that were not covered in the 2022 federal budget.

## Budget measures affecting financial institutions including banks and insurance companies

### *Canada Recovery Dividend and additional tax on banks and life insurers*

The budget proposes to impose a one-time 15% Canada Recovery Dividend (CRD) tax, as well as an additional tax of 1.5%, on banks and life insurer groups. The CRD applies to banks, and life insurers' groups, who will pay a 15% tax on taxable income above $1 billion for the 2021 tax year.

Under these rules, the 15% tax is computed based on "group" taxable income in excess of $1 billion for taxation years ending in 2021, which includes a bank or life insurer as well as other financial institutions that are related to the bank or life insurer. The budget documents note that, for purposes of the CRD, a financial institution has the meaning as defined for Part VI tax, and that the $1 billion exemption can be shared among group members by an agreement.

The CRD will be imposed for 2022 taxation years based on taxable income for taxation years ending in 2021 and paid in equal installments over five years. The draft legislation for this measure has not yet been released.

The budget also increases the corporate income tax rate by 1.5% on the taxable income of banks and life insurer groups. As a result of this change, the overall federal corporate income tax would increase to 16.5% (from 15%) for taxable income in excess of a $100 million threshold.

The budget states that the 1.5% additional tax is imposed on the same bank and life insurer groups as the CRD, and that the first $100 million taxable income exemption is shared among the group members by an agreement.

This additional tax will apply to taxation years that end after April 7, 2022.

**KPMG observations**
The definition of "financial institution" for the purposes of Part VI tax is relevant in determining the CRD and the additional tax on banks and life insurer groups, which excludes certain entities such as investment dealers. In addition, the definition may include Canadian subsidiaries of foreign banks and Canadian branches of foreign banks. Although the budget notes that the CRD will be imposed for the 2022 taxation year based on the 2021 taxable income and paid in equal installments over five years, the budget does not specify when the five-year clock starts.

### *Hedging and short selling by Canadian financial institutions*

The budget denies a deduction for dividends received where financial institutions enter into certain transactions involving hedging and short selling arrangements. Specifically, the budget:

- Denies the deduction for dividends received by a taxpayer on Canadian shares if a registered securities dealer that does not deal at arm's length with the taxpayer enters into transactions that hedge the taxpayer's economic exposure to the Canadian shares, where the registered securities dealer knew or ought to have known that these transactions would have such an effect, and

- Denies the 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 Canadian shares by entering into certain hedging transactions.

To the extent that the above situations apply, the registered securities dealer can claim a deduction equal to the lesser of the dividend compensation payment it makes and the denied deduction of the dividends received (rather than the two-third deduction under the existing legislation for registered securities dealers).

These amendments apply to dividends and related dividend compensation payments that are paid/credited, or become payable, on or after April 7, 2022, unless the relevant hedging transactions or related securities lending arrangement were in place before April 7, 2022, in which case the amendment would apply to dividends and related dividend compensation payments that are paid/credited after September 2022.

**KPMG observations**
This budget measure appears to target certain transactions such as where a Canadian taxpayer, generally a financial institution owns Canadian shares, and a related registered securities dealer borrows identical shares under a securities lending arrangement and sells the borrowed shares short. The registered securities dealer generally holds the short position during the entire period that the Canadian taxpayer, owns the Canadian shares. In this example, the Canadian taxpayer claims a deduction for the dividends received on the Canadian shares. At the same time, the registered securities dealer deducts two-thirds of the dividend compensation payments to the lender that reflect the same dividends paid on the shares. As a result, according to Finance, an artificial tax deduction equal to two-thirds of the dividend compensation payments can arise under the arrangement.

A registered securities dealer could carry out a similar transaction on its own with respect to Canadian shares that it owns. In other words, the dealer can borrow and sell short identical shares, and claim both the deduction for dividends received on its shares and a two-thirds deduction for dividend compensation payments made to the lender.

### *International Financial Reporting Standards for Insurance Contracts (IFRS 17)*

The budget includes additional guidance on the adoption of IFRS 17, the new accounting standard for insurance contracts. Specifically, this guidance supports the use of accounting income determined under IFRS 17 for income tax purposes, with certain adjustments to address the deferral of underwriting profits under this new accounting standard. The budget states that 10% of the contract service margin (CSM) on life, mortgage and title insurance contracts is deductible for tax purposes.

This measure also includes the following transitional provisions:

- A five-year transitional period for the change in reserves computed under IFRS 17
- A five-year transition period for mark-to-market gains and losses on certain fixed income securities realized on the adoption of IFRS 9
- A deduction on reserves reclassified from insurance contracts to investment contracts on the adoption of IFRS 17
- Changes to the computation of the Part VI capital tax base of life insurers to include the non-deductible portion of CSM and accumulated other comprehensive income (AOCI) and to remove the deduction of the deferred tax assets.

These measures apply effective January 1, 2023. Finance advises that legislation to support these proposals will be released in the future.

**KPMG observations**
Although the transitional provision for the mark-to-market gains and losses in the budget may have limited application, the transitional provision relating to reserves might be more relevant for insurers. In particular, the changes to the computation of the Part VI capital tax base of life insurers could have a significant impact on the industry.

### *Pillar Two — Global Minimum Tax*

The budget reiterates Canada’s commitment to implement the Pillar Two model rules released by the Organization for Economic Co-operation and Development (OECD). The budget states that Finance intends to enact a domestic minimum “top-up” tax and a primary charging rule effective in 2023, with a secondary charging rule that will come into effect not earlier than 2024. The budget also announces a public consultation process on these measures, and advises that comments must be provided to Finance by July 7, 2022.

**KPMG observations**
Financial institutions should consider the impact of Pillar Two starting for the 2023 taxation year. Financial institutions that are significantly affected by this change should consider participating in the consultation process. For more details on the global

minimum tax rules and Pillar Two, see *TaxNewsFlash-Canada* 2022-13, "OECD Pillar Two — KPMG Analysis Available Now", *TaxNewsFlash-Canada* 2022-12, "OECD Offers Guidance on Global Minimum Tax Rules", *TaxNewsFlash-Canada* 2021-63, "OECD Releases Model Global Minimum Tax Rules".

### *Reporting requirements for RRSPs and RRIFs*

The budget requires RRSP/RRIF plan sponsors, or financial institutions who administer the RRSPs and RRIFs, to annually report the total fair market value of properties held in each RRSP and RRIF that they administer, determined at the end of the calendar year. This measure would apply to the 2023 and subsequent taxation years.

**KPMG observations**
Financial institutions may have to make extensive system changes to meet these new reporting obligations.

## Budget measures affecting asset management companies and investment funds

### *Housing & real estate investment trusts*

*Review of housing as an asset class and corporate ownership of residential real estate*

The budget announces a government review of housing as an asset class to assess the role of large corporate investors in residential housing and the impact on renters and homeowners. This review will include consideration of potential changes to the tax treatment of large corporate investors in residential real estate.

The budget advises that details of the review will be released later in 2022, with potential early actions to be announced before the end of 2022.

**KPMG observations**
While not identified specifically, this housing review is likely to include an emphasis on real estate investment trusts (REITs) and their role as large investors in residential housing. As a result, the review may consider potential changes to the tax treatment of REITs. Details of the review so far remain limited, but a consultation period may be announced as part of the information to be released later in 2022. Previously, the government's 2021 election platform pledged to review the tax treatment of large corporate owners of residential real estate (such as REITs).

*Ban on foreign investment in Canadian housing*

The budget announces an intention to prohibit foreign commercial enterprises and non-resident persons from acquiring residential property in Canada for two years. The budget also notes that underused or vacant homes held by non-residents would be subject to the Underused Housing Tax once the rules are in effect.

**KPMG observations**
The budget announcement did not include details regarding whether this ban would extend on a look-through basis to indirect investors in residential property (e.g., foreign investors in Canadian REITs) or the interpretation of “foreign commercial enterprise”. These rules should be closely monitored to assess any impact on funds investing in residential property in Canada that include non-resident investors.

*New Tax-Free First Home Savings Account*

The budget creates the Tax-Free First Home Savings Account (FHSA) as a new registered account available to first-time homebuyers.

**KPMG observations**
The budget did not include details on investment restrictions for purposes of the FHSA, though it is expected that this account will be limited to similar qualified investments as other registered plans. Therefore, the FHSA may represent an additional source of investment for funds organized as qualified investments.

## *Green innovations & incentives*

*Investment tax credit for carbon capture, utilization and storage*

The budget creates a new investment tax credit for the cost of purchasing “eligible equipment” used in an “eligible project” for carbon capture, utilization and storage (CCUS). The credit rate will vary from 60% to 18.75%, depending on the type of equipment purchased and whether the expenses are incurred in the period after 2021 through 2030 or after 2030 through 2040. Eligible expenses must be verified by Natural Resources Canada. Also, to claim the credit, taxpayers must produce a climate-related financial disclosure that sets out how their corporate governance and policies will help manage climate-related risks.

The budget provides that the following are not eligible for the CCUS tax credit:

- Equipment required for hydrogen production, natural gas processing, and acid gas injection, and
- Capturing $CO_2$ by enhanced oil recovery.

*New or expanded capital cost allowance classes to encourage green investment*

The budget creates two new capital cost allowance (CCA) classes for CCUS equipment, and two new CCA classes for exploration and development expenses associated with storing carbon dioxide. The budget also expands eligibility under Classes 43.1 and 43.2, which provide accelerated rates for certain specified clean energy generation and energy conservation equipment, to include air-source heat pumps primarily used for space or water heating.

*Rate reduction for zero-emission technology manufacturers — Scope expanded to include manufacturing of air-source heat pumps*

The budget expands the scope of measures to temporarily reduce corporate income tax rates on eligible zero-emission technology manufacturing and processing income to include the manufacturing of air-source heat pumps as an eligible manufacturing and processing activities. The temporary rate reduction was announced in the 2021 federal budget.

*Green bonds*

The budget highlights the government's progress on green bonds since the 2021 federal budget. In particular, the budget notes that that the government published its green bond framework on March 3, 2022, which is intended to ensure that the net proceeds of green bonds finance eligible green expenditures. The first federal green bond was issued in March 2022, and received strong demand from investors. The budget states that another green bond issuance is planned for 2022-23.

**KPMG observations**
The budget's environment-focused tax credits and incentives reflect fine-tuning of Canada's income tax system, continued from past budgets, and are intended to have a positive environmental impact, such as reduced greenhouse gas emissions.

These proposals may be of particular interest to investors and managers of funds with environment, social and governance (ESG) strategies, as efforts to fight climate change and given the enhanced after-tax cash flow that the tax credits and incentives may provide. Also, the proposal to tie eligibility for the CCUS tax credit to climate-related financial disclosure is novel in Canada's income tax system, and is a good example of enhancing issuer governance within ESG.

### *Critical Mineral Exploration Tax Credit*

The budget proposes to introduce a new Critical Mineral Exploration Tax Credit (CMETC) for specified minerals, with an enhanced rate compared to the existing Mineral Exploration Tax Credit (METC).

Flow-through share agreements allow corporations to renounce or flow-through certain expenses to investors, who can deduct the expenses in calculating their taxable income. The existing METC provides an additional benefit for individuals who invest in mining flow-through shares, by providing a tax credit equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

The budget introduces the new CMETC equal to 30% of eligible expenditures relating to specified minerals such as copper, nickel, lithium, and cobalt. Such minerals are used in the production of batteries and permanent magnets, necessary for zero-emission vehicles or to produce advanced materials, clean technology or semi-conductors. Eligible expenditures will not benefit from both the proposed CMETC and the existing METC.

**KPMG observations**
The CMETC may be of particular interest to mining companies looking to attract financing or capital investment for their business or operations. This credit reflects the government's efforts to balance encouraging the production of minerals necessary for green technologies such as zero-emission vehicles against the potential environmental impacts from mineral exploration activities.

### *Eliminating flow-through shares for oil, gas and coal activities*

Currently, flow-through share agreements allow corporations to renounce or flow-through certain expenses to investors, who can deduct the expenses in calculating their taxable income. Canadian exploration expenses are deductible at a 100% rate, while Canadian development expenses are deductible on a 30% rate, declining balance basis.

The budget eliminates the flow-through share regime for oil, gas and coal activities by no longer allowing oil, gas and coal exploration or development expenditures to be renounced to an investor. This change applies to expenditures renounced under flow-through share agreements entered into after March 31, 2023. The budget states that the proposal "supports Canada's international commitments to phase out or rationalize inefficient fossil fuel subsidies."

**KPMG observations**
This proposal will be of interest to investors and managers of funds who offer products designed around flow-through shares, especially those who invest in shares of companies that explore and develop oil, gas and coal resources. For oil, gas and coal companies, the sunset clause for the phase-out of this program will be of particular importance for those planning new offerings. It's not yet clear whether revisions to the existing and soon-to-be phased out flow-through share program may be re-engineered to focus on carbon reduction projects.

## Other measures previously introduced

The financial services industry should also monitor certain other previously announced measures that were not covered in this year's federal budget to determine their impact, including:

- Excessive interest and financing expenses limitation (earnings stripping), generally effective for tax years beginning after December 31, 2022 (Finance will accept comments on this measure until May 5, 2022)

- Mandatory disclosure rules, generally effective for tax years beginning after December 31, 2021

- Mutual funds — allocation to redeemers, effective for tax years beginning after December 15, 2021

- Trust beneficiary reporting, effective for tax years ending after December 30, 2022.

For further details on these proposals, see *TaxNewsFlash-Canada* 2022-05, "Finance Issues Outstanding Interest Expense Rules & More".

## We can help

Your KPMG adviser can help you assess the effect of the tax changes in this year's federal budget on the financial services industry, and point out ways to take advantage of their benefits or ease their impact. We can also keep you abreast of the progress of these proposals as they make their way into law.