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TaxNewsFlash

Canada

2023 Federal Budget — Spotlight on Financial Services

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Companies in the financial services industry may be affected by new measures in the 2023 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:

- Dividend deduction
- Tax on repurchases of equity
- Pillar II — Global Minimum Tax
- GST/HST treatment of payment card clearing services.

In addition, asset management companies may want to review the following new 2023 federal budget measures to determine how they are affected:

- Tax on repurchases of equity
- Alternative Minimum Tax for high income individuals
- Flow-through shares and Critical Mineral Exploration Tax Credit — Lithium from brines
- Environment-focused tax credits and incentives
- Tax treatment of credit unions.

In addition to these measures, affected companies should also be aware of other previously announced measures that were not covered in the 2023 federal budget.

Budget measures affecting financial institutions including banks and insurance companies

Dividend deduction

The budget proposes to deny the dividend received deductions for dividends received by financial institutions on shares that are mark-to-market property.

The mark-to-market rules apply to certain property ("mark-to-market property") held by financial institutions in the ordinary course of their business. Under these rules, unrealized gains are included in computing income annually and realized gains on the disposition of mark-to-market property are included in ordinary income, not capital gains. Shares are generally mark-to-market property when a financial institution has less than 10% of the votes or value of the corporation that issued the shares ("portfolio shares") and is not related to the issuer.

For purposes of these rules, financial institutions generally include banks, trust companies, credit unions, insurance corporations, corporations whose principal business is the lending of money to arm's-length persons and/or purchasing of debt obligations issued by arm's-length persons, registered securities dealers, corporations controlled by financial institutions, as well as certain other corporations whose assets are almost substantially all comprised of shares and debt of related financial institutions. Mutual fund corporations and certain other corporations are excluded.

The dividend received deduction is intended to limit the imposition of multiple levels of corporate taxation as funds are distributed through corporate groups.

The elimination of the dividend received deduction results in all income earned by financial institutions in respect of mark-to-market property being taxed as business income.

These changes are proposed to apply to dividends received after 2023.

KPMG observations

The budget's proposal to deny dividend received deduction for financial institutions which hold such shares as mark to market property. Financial institutions affected by this proposal will be required to analyze the source of all Canadian dividends received to determine if they are held as mark-to-market property or otherwise to determine if the dividend deduction will be denied. This Is likely to impact the effective tax rate for financial institutions which receive a material amount of Canadian dividend in earnings.

Tax on repurchases of equity

The budget provides the details on the proposed 2% tax on the net value of all types of share repurchases by public corporations in Canada. This tax, which was first announced in the 2022 Fall Economic Statement, applies to Canadian-resident public corporations, real estate investment trusts (REITs), specified investment flow-through (SIFT) trusts and SIFT partnerships where the shares/units are listed on a designated stock exchange. The tax would not apply to mutual fund corporations.

KPMG observations

In recent decades, share buybacks have overtaken dividends as a preferred way for financial institutions to return cash to shareholders. This method can be more tax advantageous for investors rather then receiving a dividend. Companies often repurchase their shares in order to reduce the cost of capital, as well as to consolidate ownership consolidation, preserving stock prices, undervaluation, and to boost their key financial ratios. It will be interesting whether the proposed legislation has an impact on a company's decision regarding the scheme chosen for capital reorganization transactions.

It will also be interesting to see how the proposed 2% tax will be treated for tax purposes both in the domestic and foreign affiliate context.

Pillar Two — Global Minimum Tax

The budget announces the government's intention to introduce legislation implementing the Income Inclusion Rule (IIR) and a domestic minimum top-up tax applicable to Canadian entities of MNEs with annual revenues of €750 million or more. This announcement is consistent the government's previous statements in the 2022 federal budget.

The legislation implementing the IIR and domestic minimum top-up tax will apply for fiscal years of MNEs that begin on or after December 31, 2023.

The budget also announces the implementation of the Undertaxed Profits Rule (UTPR) under the Pillar Two framework with effect for fiscal years of MNEs that begin on or after December 31, 2024.

KPMG observations

The government intends to release draft legislative proposals for the IIR and domestic minimum top-up tax for public consultation in the coming months, with draft legislative proposals for the UTPR to follow at a later time.

GST/HST treatment of payment card clearing services

The budget clarifies that payment card clearing services rendered by a payment card network operator are generally subject to the GST/HST. Specifically, the budget excludes these services from the definition of “financial service” under the GST/HST rules.

This measure would apply to a service rendered under an agreement for a supply if any consideration for the supply becomes due, or is paid without becoming due, after March 28, 2023. This measure would also apply to a service rendered under an agreement for a supply if all of the consideration for the supply became due, or was paid, on or before March 28, 2023, except in certain situations, such as where the following conditions are both met:

- The supplier did not, on or before March 28, 2023, charge, collect or remit any amount as or on account of tax in respect of the supply and
- The supplier did not, on or before March 28, 2023, charge, collect or remit any amount as or on account of tax in respect of any other supply that is made under the agreement and that includes the provision of a payment card clearing service.

KPMG observations
KPMG can assist credit card issuers, payment processors, and merchant acquirers (including banks, credit unions and others) that had stopped paying GST/HST on network operator fees and had filed rebate claims or requests to amend past returns if these measures affect their previous years filed.

Budget measures affecting asset management companies

Tax on repurchases of equity

Asset managers may also be affected by proposed 2% tax on the net value of all types of share repurchases by public corporations in Canada that also affects financial institutions. This measure is described above.

KPMG observations
Asset managers should be aware that these measures notably extend the 2% tax to mutual fund trusts that are REITs or SIFT trusts, as well to SIFT partnerships where the shares or units are listed on a designated stock exchange.

Alternative Minimum Tax for high income individuals

The budget proposes several changes to calculation of the Alternative Minimum Tax (AMT), including to broaden the base on which the tax is calculated, raise the AMT exemption to approximately $173,000 (from $40,000) and increase the AMT rate to 20.5% (from 15%).

KPMG observations
The budget notes that mutual fund trusts and other trusts that are currently exempt from AMT will continue to be exempt. However, unit trusts that are not mutual fund trusts may be adversely affected by these changes which:

- Increase the inclusion rate on capital gains to 100% (from 80%) and apply capital loss carryforwards at a 50% rate, and
- Disallow 50% of certain deductions including carrying charges incurred to earn income from property and non-capital loss carryovers (note that the scope of carrying charges that may be restricted is currently unclear).

The budget further notes that the government will examine whether additional types of trusts should be exempt from the AMT. While not specified in the budget documents, this may include consideration whether unit trusts that are not mutual fund trusts may be excluded from these rules.

Flow-through shares and Critical Mineral Exploration Tax Credit — Lithium from brines

The budget amends the Act to include lithium from brines as a mineral resource and expands the eligibility of the Critical Mineral Exploration Tax Credit (CMETC) to include lithium from brines. As a result, relevant principal-business corporations that undertake certain exploration and development activities can issue flow-through shares and renounce expenses to their investors.

Eligible expenses related to lithium from brines made after March 28, 2023 will qualify as Canadian exploration expenses and Canadian development expenses. The expansion of the eligibility of the CMETC to lithium from brines applies to flow-through share agreements entered into after March 28, 2023 and before April 2027.

KPMG observations
The proposed expansion of the CMETC may be of particular interest to asset managers that manufacturer flow through share fund products as well as mining companies looking to attract financing or capital investment for their business or operations. This proposal 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.

Environment-focused tax credits and incentives

Clean Hydrogen Investment Tax Credit

The budget announces the details of the Clean Hydrogen Investment Tax Credit, which provides various levels of support between 15% and 40% of eligible project costs, with the projects that produce the cleanest hydrogen receiving the highest levels of support. Taxpayers will also have to meet labour requirements to receive the maximum tax credit rates.

Tax Credit for Clean Technology Manufacturing

The budget proposes a refundable tax credit equal to 30% of the cost of investments in new machinery and equipment used to manufacture or process key clean technologies, and extract, process, or recycle key critical minerals, including:

- Extraction, processing, or recycling of critical minerals essential for clean technology supply chains, specifically: lithium, cobalt, nickel, graphite, copper, and rare earth elements
- Manufacturing of renewable or nuclear energy equipment
- Processing or recycling of nuclear fuels and heavy water
- Manufacturing of grid-scale electrical energy storage equipment
- Manufacturing of zero-emission vehicles, and
- Manufacturing or processing of certain upstream components and materials for the above activities, such as cathode materials and batteries used in electric vehicles.

The investment tax credit is expected to cost $4.5 billion over five years, starting in 2023-24, and an additional $6.6 billion from 2028-29 to 2034-35.

Expanding eligibility for the Clean Technology Investment Tax Credit

The budget proposes to expand eligibility for the Clean Technology Investment Tax Credit to include geothermal energy systems that are eligible for capital cost allowance Classes 43.1 and 43.2. The Clean Technology Investment Tax Credit would be available to businesses investing in such property that is acquired and becomes available for use on or after March 28, 2023. Projects that will co-produce oil, gas, or other fossil fuels would not be eligible for the Clean Technology Investment Tax Credit.

Rate reduction for zero-emission technology manufacturers

The budget proposes to extend the availability of the 50% reduction to corporate income tax rates for zero-emission technology manufacturers by another three years, such that the reduced tax rates would no longer be in effect for taxation years starting after 2034, subject to a phase-out starting in 2032.

The budget also proposes to extend eligibility for the reduced rates to include the manufacturing of nuclear energy equipment and the processing and recycling of nuclear fuels and heavy water, effective for taxation years beginning after 2023.

Strategic Innovation Fund for Clean Energy Projects

The budget proposes to provide $500 million over ten years to the Strategic Innovation Fund to support the development and application of clean technologies in Canada. The Strategic Innovation Fund will also direct up to $1.5 billion of its existing resources towards projects in sectors including clean technologies, critical minerals, and industrial transformation.

KPMG observations
The budget's proposed environment-focused tax credits and funding incentives reflect Canada's continued efforts to adjust the tax rules promote 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.

Tax treatment of credit unions

The budget eliminates the revenue test from the definition of "credit union". In some cases, credit unions that earn more than 10% of their revenue from certain sources (such as interest income from lending activities to non-members) would not qualify for the definition and subsequently face unforeseen income tax and GST/HST consequences. The amendment applies for taxation years of a credit union ending after 2016.

Other measures previously introduced

The budget confirms that Finance intends to proceed with certain previously announced tax measures, as modified by recent consultations and deliberations. These measures include:

- Excessive Interest and Financing Expenses Limitations
- Reporting rules for digital platform operators
- Investment Tax Credit for Clean Technologies
- Borrowing by defined benefit pension plans

- Reporting requirements for RRSPs and RRIFs
- Fixing contribution errors in defined contribution pension plans
- Investment tax credit for Carbon Capture, Utilization, and Storage
- Hedging and short selling by Canadian financial institutions
- Substantive Canadian-controlled private corporations
- Mandatory disclosure rules
- Electronic filing and certification of tax and information returns
- Other technical amendments proposed on August 9, 2022
- Remaining legislative and regulatory proposals relating to the GST/HST, excise levies and other taxes and charges proposed on August 9, 2022
- Hybrid mismatch arrangements
- GST/HST treatment of crypto-asset mining
- The transfer pricing consultation announced in the 2021 federal budget
- Legislative proposals tabled in a Notice of Ways and Means Motion on December 14, 2021 to introduce the *Digital Services Tax Act*

The budget also confirms the government's commitment to move forward with technical amendments to improve the certainty and integrity of the tax system.

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.

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