

# TAX TALK

## 2023 FEDERAL BUDGET HIGHLIGHTS

On March 28, 2023, the Deputy Prime Minister and Finance Minister, the Honourable Chrystia Freeland, presented the 2023 Federal Budget.

No changes were announced to the personal or corporate income tax rates, nor the inclusion rate on taxable capital gains. Some highlights include:

### A. Personal Measures

#### *Alternative Minimum Tax (AMT) for High-Income Individuals*

Individuals will owe AMT if the tax amount calculated under the AMT regime is greater than the tax calculated under the ordinary progressive tax rate regime.

Under the current rules, the calculation of AMT allows fewer deductions, exemptions and tax credits than under the ordinary income tax rules and applies a flat 15% tax on income over a standard \$40,000 exemption.

Budget 2023 proposes several changes to the AMT calculation.

First, the AMT rate is proposed to increase from 15% to 20.5%.

Second, the exemption would increase from \$40,000 to approximately \$173,000.

Third, the AMT base would be broadened by further limiting tax preferences (i.e., exemptions, deductions and credits) as follows:

- The capital gains inclusion rate would increase from 80% to 100%.
- 30% of capital gains eligible for the lifetime capital gains exemption would be included.
- Deductions of capital loss carry forwards and allowable business investment losses would apply at a 50% rate.
- 100% of employee stock options benefits would be included.

- 30% of capital gains on donations of publicly listed securities would be included.
- Only 50% of many deductions would be allowed, including the following: employment expenses (other than those incurred to earn commission income); moving expenses; child care expenses; interest and carrying charges incurred to earn income from property; northern residents deduction; and non-capital and limited partnership losses of other years.
- Only 50% of non-refundable tax credits historically allowed for AMT purposes would be allowed.

The ability to recover AMT in the seven subsequent years, to the extent that tax computed under the ordinary progressive tax rate regime exceeds AMT, is not proposed to change.

The proposed changes would come into force for the 2024 personal tax year.

#### *Grocery Rebate*

Individuals and families with modest incomes receive the Goods and Services Tax Credit (GSTC). The maximum 2022/2023 GSTC is \$467 for a single person, and \$612 plus \$161 per child for a married or common-law couple.

Budget 2023 proposes a one-time payment called the Grocery Rebate which will equal half of the annual maximum (twice the quarterly payment received in January, 2023) to be paid as soon as possible after the legislation is passed.

#### *Deduction for Tradespeople's Tool Expenses*

Under the current law, a tradesperson can claim a deduction of up to \$500 of eligible new tools acquired in a taxation year as a condition of employment.

Budget 2023 proposes to double the maximum employment deduction for tradespeople's tools from \$500 to \$1,000, effective for 2023 and subsequent taxation years.

As a consequence of this change, extraordinary tool costs that are eligible to be deducted under the apprentice vehicle mechanics' tools deduction would be those costs that exceed the combined amount of the increased deduction for tradespeople's tool expenses (\$1,000) and the Canada employment credit (\$1,368 in 2023) or 5% of the taxpayer's income earned as an apprentice mechanic, whichever is greater.

### *Registered Education Savings Plans (RESPs)*

Government grants and investment income can be withdrawn from RESPs as an education assistance payment (EAP) when a beneficiary is enrolled in an eligible post-secondary program. These withdrawals are taxable.

Under the current law, beneficiaries that are full-time students cannot withdraw more than \$5,000 in EAPs in respect of the first 13 consecutive weeks of enrollment in a 12-month period. For part-time students, the limit is \$2,500 per 13-week period.

Budget 2023 proposes to increase these limits to \$8,000 for full-time students and \$4,000 for part-time students.

Budget 2023 also proposes to enable divorced or separated parents to open joint RESPs for one or more of their children or to move an existing joint RESP to another promoter. Under the current law, only spouses or common-law partners can jointly enter into an agreement with an RESP promoter to open an RESP.

These changes would come into force on Budget Day.

## **B. Business Measures**

### *Strengthening the Intergenerational Business Transfer Framework*

Historically where parents transferred shares of their corporation to a corporation owned by their children, deemed dividends rather than capital gains would arise on the disposition.

In 2021, legislation was passed (Bill C-208) to provide an exception from this deemed dividend treatment to facilitate the transfer of family businesses to the next generation. This exception allowed parents to utilize the lifetime capital gains exemption or simply receive capital gain treatment on the disposition, and enjoy the same tax benefits available on a sale to unrelated third parties.

However, the government was concerned that this exception contained insufficient safeguards and may have provided an inappropriate tax advantage where there was no transfer of a business to the next generation.

More specifically, this exception did not require that:

- the parent cease to control the underlying business of the corporation whose shares are transferred,
- the child(ren) purchasing the shares have any involvement in the business,
- the interest in the purchaser corporation held by the child(ren) continue to have value, or
- the child(ren) retain an interest in the business after the transfer.

### *Proposed Amendments*

Budget 2023 proposes to amend these rules to ensure that they apply only where a genuine intergenerational business transfer (IBT) takes place.

A genuine IBT under the current law would be a transfer of shares of a corporation (the Transferred Corporation) by an individual shareholder (the Transferor) to another corporation (the Purchaser Corporation) where both of the following conditions are satisfied:

1. each share of the Transferred Corporation must be a "qualified small business corporation share" or a "share of the capital stock of a family farm or fishing corporation" (both as defined in the Income Tax Act), at the time of the transfer (in general terms, this requires that all or substantially all of its assets be used in an active business carried on in Canada); and
2. the Purchaser Corporation must be controlled by one or more persons each of whom is an adult child of the Transferor (the meaning of "child" for these purposes would include grandchildren, stepchildren, children-in-law, nieces and nephews, and grandnieces and grandnephews).

To ensure that only genuine IBTs are excluded from the deemed dividend rules, Budget 2023 proposes additional conditions be added. To provide flexibility, taxpayers who wish to undertake a genuine IBT may choose to rely on one of two transfer options:

1. an immediate business transfer (three-year test) based on arm's length sale terms; or
2. a gradual business transfer (five-to-ten-year test) based on traditional estate freeze characteristics (an estate freeze typically involves a parent crystallizing the value of their economic interest in a corporation into shares that no longer share in growth in the corporate value to allow future growth to accrue to their children while the parent's fixed economic interest is then gradually diminished by the corporation repurchasing the parent's shares).

The immediate transfer rule would provide finality earlier in the process, though with more stringent conditions. In recognition that not all business transfers are immediate, the gradual transfer rule would provide additional flexibility for those who choose that approach.

Budget 2023 also proposes to provide a ten-year capital gains reserve for genuine intergenerational share transfers that satisfy the above proposed conditions, which would allow capital gains to be brought into income over a period of up to ten years, in proportion to proceeds received. The normal limit for such reserves is five years.

These rules would apply to share sales occurring on or after January 1, 2024.

### *Employee Ownership Trusts (EOTs)*

An EOT is a form of employee ownership where a trust holds shares of a corporation for the benefit of the corporation's employees. EOTs can be used to facilitate the acquisition by employees of their employer's business, without requiring them to pay directly to acquire shares. This will provide business owners an additional option for succession planning. Budget 2023 proposes new rules to facilitate the use of EOTs to acquire and hold shares of a business.

The following subsections describe the general rules that would apply to EOTs. Complex requirements are set out in draft legislation included in the Budget papers.

### Definitions

To be an EOT, a trust would be required to be resident in Canada (excluding deemed resident trusts) and have only two purposes. First, it would hold shares of qualifying businesses for the benefit of the employee beneficiaries of the trust. Second, it would make distributions to employee beneficiaries, where reasonable, under a distribution formula that could only consider an employee's length of service, remuneration and hours worked. Otherwise, all beneficiaries must generally be treated in a similar manner.

An EOT would be required to hold a controlling interest in the shares of the qualifying business. A qualifying business would need to meet certain conditions. It would be required to be a Canadian-controlled private corporation. All or substantially all of the fair market value of its assets must be attributable to assets used in an active business carried on in Canada. A qualifying business would not be able to carry on business as a partner in a partnership. An EOT would not be permitted to allocate shares of a qualifying business to individual beneficiaries.

Trustees of the EOT would be elected by the beneficiaries every five years. Individuals who held a significant economic interest in a business prior to its acquisition by the EOT would not be able to make up more than 40% of the trustees of the EOT, the directors of a corporation serving as a trustee of the EOT or the directors of any qualifying business owned by the EOT. This limit would also include persons related to such individuals.

Trust beneficiaries would be limited to qualifying employees. Individuals, and persons related to them, who hold, or held prior to the disposition to the EOT, a significant economic interest in the business would be excluded from being qualifying employees.

### The Tax Treatment

The EOT would be a taxable trust and will be generally subject to the same rules as other personal trusts. Therefore, undistributed trust income would be taxed in the EOT at the top personal marginal tax rate. If the EOT distributes dividends received from the qualifying business, those dividends would retain their character when received by employee beneficiaries and would be eligible for the dividend tax credit.

## Qualifying Business Transfer

A qualifying business transfer would occur when a taxpayer disposes of shares of a qualifying business for proceeds that do not exceed fair market value. The shares must be disposed of to either a trust that qualifies as an EOT immediately after the sale or a corporation owned 100% by the EOT. The EOT must own a controlling interest in the qualifying business immediately after the qualifying business transfer.

## Benefits

1. A ten-year capital gain reserve would be available, therefore allowing capital gains to be brought into income over a period of up to ten years, in proportion to proceeds received. The normal limit for such reserves is five years.
2. A loan from the qualifying business to the EOT for the purchase of the shares of the qualifying business could be repaid within 15 years, an exception to the usual rule that loans to a shareholder are included in income if not repaid by the end of the following fiscal year.
3. The EOT would be able to hold the shares indefinitely without being deemed to realize capital gains. Most trusts are deemed to realize all gains accumulated in their assets every 21 years.

These amendments would apply as of January 1, 2024.

## *Clean Electricity Investment Tax Credit*

Budget 2023 proposes to introduce a 15% refundable tax credit for eligible investments in:

- non-emitting electricity generation systems: wind, concentrated solar, solar photovoltaic, hydro (including large-scale), wave, tidal, and nuclear (including large-scale and small modular reactors);
- abated natural gas-fired electricity generation (which would be subject to an emissions intensity threshold compatible with a net-zero grid by 2035);
- stationary electricity storage systems that do not use fossil fuels in operation, such as batteries, pumped hydroelectric storage, and compressed air storage; and
- equipment for the transmission of electricity between provinces and territories.

Both new projects and the refurbishment of existing facilities will be eligible. Taxable and non-taxable entities such as Crown corporations and publicly owned utilities, corporations owned by Indigenous communities, and pension funds, would be eligible. The clean electricity investment tax credit could be claimed in addition to the Atlantic investment tax credit, but generally not with any other investment tax credit.

In order to access the tax credit in each province and territory, other requirements will include a commitment by a competent authority that the federal funding will be used to lower electricity bills, and a commitment to achieve a net-zero electricity sector by 2035.

The clean electricity investment tax credit would be available as of Budget Day 2024 for projects that did not begin construction before Budget Day 2023. The credit would not be available after 2034.

## *Clean Hydrogen Investment Tax Credit*

Budget 2023 proposes to introduce the clean hydrogen refundable investment tax credit for investments made in clean hydrogen production based on the lifecycle carbon intensity of hydrogen (previously noted in the 2022 Fall Economic Statement). The amount of the credit, which ranges from 15% to 40%, is based on assessed carbon intensity of the hydrogen that is produced (i.e., kilogram (kg) of carbon dioxide equivalent (CO<sub>2</sub>e) per kg of hydrogen).

The credit would be available in respect of the cost of purchasing and installing eligible equipment for projects that produce hydrogen from electrolysis or natural gas (so long as emissions are abated using carbon capture, utilization and storage).

Property that is required to convert clean hydrogen to clean ammonia would also be eligible for the credit, at the lowest credit rate of 15%.

This measure would apply to property that is acquired and that becomes available for use on or after Budget Day. The credit would be fully phased out for property that becomes available for use after 2034.

## *Clean Technology Investment Tax Credit*

The 2022 Fall Economic Statement proposed a 30% clean technology investment tax credit for Canadian businesses adopting in clean technology and investing in eligible property that is acquired and that becomes available for use on or after Budget Day 2023. Eligible capital costs include investments in:

- electricity generation systems, including solar photovoltaic, small modular nuclear reactors, concentrated solar, wind, and water (small hydro, run-of-river, wave, and tidal);
- stationary electricity storage systems that do not use fossil fuels in their operation, including but not limited to: batteries, flywheels, supercapacitors, magnetic energy storage, compressed air storage, pumped hydro storage, gravity energy storage, and thermal energy storage;

- low-carbon heat equipment, including active solar heating, air-source heat pumps and ground-source heat pumps; and
- industrial zero-emission vehicles and related charging or refuelling equipment, such as hydrogen or electric heavy-duty equipment used in mining or construction.

Budget 2023 proposes to expand eligibility of the tax credit to include geothermal energy systems that are eligible for Class 43.1 of Schedule II of the Income Tax Regulations. The expansion would apply in respect of property that is acquired and becomes available for use on or after Budget Day, where it has not been used for any purpose before its acquisition.

The phase-out of the credit would commence in 2034, rather than 2032 as previously announced.

### *Investment Tax Credit for Carbon Capture, Utilization and Storage (CCUS)*

Budget 2022 proposed a refundable investment tax credit for the cost of purchasing and installing eligible equipment used in an eligible CCUS project for businesses that incur eligible expenses starting on January 1, 2022.

Budget 2023 proposes the following changes in respect of the CCUS, with details to be released in the coming months:

- Dual use equipment that produces heat and/or power or uses water, that is used for CCUS as well as another process, would be eligible for the CCUS tax credit on a pro-rated basis in proportion to the expected energy balance or material balance supporting the CCUS process over the first 20 years of the project.
- British Columbia would be added to the list of eligible jurisdictions for dedicated geological storage, applicable to expenses incurred on or after January 1, 2022.
- Credits related to eligible refurbishment costs incurred once the project is operating would be calculated based on the average of the expected eligible use ratio for the five-year period (the period) in which they are incurred, and each subsequent period (i.e., the periods over which they contribute to the useful life of the project).

These measures would apply to eligible expenses incurred after 2021 and before 2041.

### *General Anti-Avoidance Rule (GAAR)*

The GAAR in the Income Tax Act is intended to prevent abusive tax avoidance transactions while not interfering with legitimate commercial and family transactions. If abusive tax avoidance is established, the GAAR applies to deny the tax benefit created by the abusive transaction.

A consultation on various approaches to modernizing and strengthening the GAAR has recently been conducted. A consultation paper released last August identified a number of issues with the GAAR and set out potential ways to address them. As part of the consultation, the government received a number of submissions, representing a wide variety of viewpoints.

#### *Preamble*

A preamble would be added to the GAAR, in order to help address interpretive issues and ensure that the GAAR applies as intended. While the GAAR informs the interpretation of, and applies to, every other provision of the Income Tax Act, it fundamentally denies tax benefits sought to be obtained through abusive tax avoidance transactions. It in effect draws a line: while taxpayers are free to arrange their affairs so as to obtain tax benefits intended by Parliament, they cannot misuse or abuse the tax rules to obtain unintended benefits.

The preamble would also clarify that the GAAR is intended to apply regardless of whether or not the tax planning strategy used to obtain the tax benefit was foreseen.

#### *Avoidance Transaction*

The threshold for an “avoidance transaction” potentially subject to the GAAR would be reduced from a “primary purpose” test to a “one of the main purposes” test. This is consistent with the standard used in many modern anti-avoidance rules in other countries and is considered by the government to strike a reasonable balance, as it would apply to transactions with a significant tax avoidance purpose but not to transactions where tax was simply a consideration.

## Economic Substance

A rule would be added to the GAAR to better meet the objective of requiring economic substance, in addition to literal compliance with the words of the Income Tax Act. Currently, Supreme Court of Canada jurisprudence has established a more limited role for economic substance.

The proposed amendments would provide that economic substance is to be considered at the 'misuse or abuse' stage of the GAAR analysis and that a lack of economic substance tends to indicate abusive tax avoidance. A lack of economic substance will not always mean that a transaction is abusive.

It would still be necessary to determine the object, spirit and purpose of the provisions or scheme relied upon, in line with existing GAAR jurisprudence. In cases where the tax results sought are consistent with the purpose of the provisions or scheme relied upon, abusive tax avoidance would not be found even in cases lacking economic substance.

The amendments would provide indicators for determining whether a transaction or series of transactions lacks economic substance.

These are not an exhaustive list of factors that might be relevant and different indicators might be relevant in different cases. However, in many cases, the government believes that the existence of one or more of these indicators would strongly point to a transaction lacking economic substance. These indicators are:

1. whether there is the potential for pre-tax profit;
2. whether the transaction has resulted in a change of economic position; and
3. whether the transaction is entirely (or almost entirely) tax motivated.

Budget 2023 provided the example of an individual contributing to a tax-free savings account. Such a transfer could be considered to be entirely tax motivated, with no change in economic position or potential for profit other than as a result of tax savings. Even if the transfer is considered to be lacking in economic substance, it is clearly not a misuse or abuse of the relevant provisions of the Income Tax Act.

The individual is using their tax-free savings account in precisely the manner that Parliament intended. There are contribution rules that specifically contemplate such a transfer and, perhaps more fundamentally, the basic tax-free savings account rules would not work if such a transfer was considered abusive.

The proposal would not supplant the general approach under Canadian income tax law, which focuses on the legal form of an arrangement. In particular, it would not require an enquiry into what the economic substance of a transaction actually is (e.g., whether a particular financial instrument is, in substance, debt or equity). Rather, it would require consideration of a lack of economic substance in the determination of abusive tax avoidance.

## Penalty

A penalty would be introduced for transactions subject to the GAAR, equal to 25% of the amount of the tax benefit. Where the tax benefit involves a tax attribute that has not yet been used to reduce tax, the amount of the tax benefit would be considered to be nil. The penalty could be avoided if the transaction is disclosed to CRA, either as part of mandatory disclosure rules which are currently proposed or voluntarily.

## Reassessment Period

A three-year extension to the normal reassessment period would be provided for GAAR assessments, unless the transaction had been disclosed to CRA as discussed above.

## Consultation

Budget 2023 announced a consultation on these proposals to close on May 31, 2023. Following this consultation, the government intends to publish revised legislative proposals and announce the application date of the amendments.

## C. Sales and Excise Tax

### *Alcohol Excise*

Alcohol excise duties are automatically indexed to total Consumer Price Index (CPI) inflation at the beginning of each fiscal year (i.e., on April 1st). Budget 2023 proposes to temporarily cap the inflation adjustment for excise duties on beer, spirits and wine at 2%, for one year only, as of April 1, 2023.

### *Cannabis Taxation – Quarterly Duty Remittances*

Excise duties are imposed on cannabis products, and are generally remittable on a monthly basis. Budget 2022 brought forward a measure that allowed certain smaller licensed cannabis producers to remit excise duties on a quarterly basis.

Budget 2023 proposes to allow all licensed cannabis producers to remit excise duties on a quarterly rather than monthly basis, starting from the quarter beginning on April 1, 2023.

## D. Other Measures

### *Small Business Credit Card Fees*

Budget 2023 announced that commitments had been obtained from Visa and MasterCard to lower fees for small businesses. More than 90% of credit card-accepting businesses are expected to see their fees reduced by up to 27%.

### *Automatic Tax Filing for Low-income Canadians*

Budget 2023 announced that the number of Canadians eligible for CRA's automatic File My Return service will be increased to 2 million by 2025, almost tripling the number of currently eligible Canadians.

In 2022, 53,000 returns were filed using this service. In addition, a new pilot project will be implemented to assist vulnerable Canadians in applying for benefits even if they do not file tax returns.

### *Student Benefits*

Budget 2023 proposes increasing Canada student grants by 40%, raising the interest-free Canada student loan limit from \$210 to \$300 per study week, and waiving the requirement for mature students (aged 22 or older) to undergo credit screening in order to qualify.

### *Dental Care for Canadians*

The Canadian dental care plan would provide coverage for all uninsured Canadians with an annual family income of less

than \$90,000 (the Canada dental benefit only provided benefits for children under 12) by the end of 2023. The plan will be administered by Health Canada, with support from a third-party benefit's administrator. Benefits are reduced for families with income between \$70,000 and \$90,000.

## E. Previously Announced Measures

Budget 2023 confirms the government's intention to proceed with the following previously announced tax and related measures, as modified to take into account consultations and deliberations since their release.

- Tax measures announced in the Fall Economic Statement on November 3, 2022, for which legislative proposals have not yet been released, including: automatic advance for the Canada workers benefit; investment tax credit for clean technologies; and extension of the residential property-flipping rule to assignment sales.
- Legislative proposals released on August 9, 2022, including with respect to the following measures:
  - substantive Canadian-controlled private corporations;
  - mandatory disclosure rules;
  - the electronic filing and certification of tax and information returns;
  - other technical amendments to the Income Tax Act and Income Tax Regulations proposed in the August 9th release; and
  - remaining legislative and regulatory proposals relating to the Goods and Services Tax/Harmonized Sales Tax, excise levies and other taxes and charges announced in the August 9th release.
- Legislative proposals released on February 4, 2022 with respect to the Goods and Services Tax/Harmonized Sales Tax treatment of crypto asset mining.
- Legislative proposals tabled in a Notice of Ways and Means Motion on December 14, 2021 to introduce the Digital Services Tax Act.
- The transfer pricing consultation announced in Budget 2021.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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