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Federal Budget 2023 – Major Changes for Business and High Net Worth Individuals

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On March 28, 2023 (Budget Day), the Honourable Chrystia Freeland, Deputy Prime Minister of Canada and Minister of Finance, delivered the Liberal Party's federal budget (Budget 2023).

Budget 2023 does not change the corporate and personal tax rates under the *Income Tax Act* (Act). Instead it makes the following changes of particular relevance to business:

- Substantially revising the alternative minimum tax (AMT) rules for 2024 and subsequent years. Budget 2023 does not raise the capital gains inclusion rate, but these changes could result in additional tax on capital gains and stock options realized after 2023.
- Revising the general anti-avoidance rule (GAAR), expanding the scope of the GAAR and imposing penalties where the GAAR applies.
- Implementing the previously announced 2% tax on public corporations and other publicly traded entities that repurchase equity interests.
- Eliminating the dividend-received deduction (DRD) for financial institutions that receive dividends from portfolio companies.
- Amending the rules on intergenerational transfers of businesses and introducing the previously announced employee ownership trusts (EOT).
- Providing further detail and enhancements to clean energy tax credits and incentives. These include a credit for certain expenditures related to clean technology manufacturing and processing and the extraction and certain processing activities related to six critical minerals essential for clean technology supply chains: lithium, cobalt, nickel, graphite, copper and rare earth elements.

From an international tax perspective, Budget 2023 reaffirms the government's support for the Organisation for Economic Co-operation and Development's (OECD) Pillar One and Pillar Two initiatives. Budget 2023 also announces new sales and excise tax measures. We discuss a number of these measures below.

Business Income Tax Measures

Sweeping Changes to the GAAR

The GAAR can apply to redetermine the tax consequences otherwise arising under the Act, where a transaction or series of transactions contains an "avoidance transaction" and results directly or indirectly in a "tax benefit." This applies only in circumstances giving rise to a misuse or abuse of the provisions of the Act or of the Act as a whole. Historically, most GAAR decisions have turned on whether a misuse or abuse has occurred.

Budget 2023 provides further details on previously announced changes to the GAAR to significantly expand its scope by proposing an economic substance test added to the misuse and abuse analysis. The Budget also proposes to add a new preamble to the GAAR, broaden the meaning of "avoidance transaction" for purposes of the GAAR, extend the statutory limitation period for GAAR reassessments and impose a 25% penalty where the GAAR applies.

The proposed amendments provide that if an avoidance transaction is "significantly lacking in economic substance", it "tends to indicate" a misuse or abuse for purposes of the GAAR. The draft legislation includes a list of broad, non-exhaustive factors, which "tend to establish" that a transaction or series of transactions is significantly lacking in economic substance, including: whether there is the potential for pre-tax profit; whether the transaction has resulted in a change of economic position; and whether the transaction is entirely (or almost entirely) tax motivated.

Budget 2023 also proposes to add a preamble to the GAAR "to help address interpretive issues and ensure that the GAAR applies as intended". A portion of the proposed preamble appears to codify the judicial principle that the GAAR is intended to strike a balance between taxpayers' need for certainty in planning their affairs and the government's interest in preventing abusive tax avoidance (framed in Budget 2023 as the government's responsibility to "protect the tax base and the fairness of the tax system"). The proposed preamble also provides that the GAAR can apply regardless of whether a tax-planning strategy was foreseen, thus overriding prior judicial commentary.

The Budget 2023 proposes to amend the GAAR to expand the scope of the term "avoidance transaction." Currently, an avoidance transaction requires that a transaction be "primarily" tax motivated. The applicable standard has been reduced so that a transaction will be an avoidance transaction if it can reasonably be considered that "one of the main purposes" of the transaction is to obtain a tax benefit.

Budget 2023 proposes to extend the statutory limitation period by three years when an assessment or reassessment is made to give effect to the application of the GAAR in respect of a transaction. It also introduces an optional disclosure regime whereby taxpayers can disclose a transaction under the "reportable transaction" rules on an optional and voluntary basis. Where disclosure is made under the reportable transaction rules (whether on an optional or a mandatory basis), the usual statutory limitation period applies to a reassessment of that transaction under the GAAR.

Budget 2023 also proposes to introduce a penalty where the GAAR applies. The proposed penalty is equal to 25% of the amount of the tax benefit that would have been achieved but-for the application of the GAAR. For these purposes, a tax benefit relating to the creation or preservation of tax attributes is deemed to be nil. The penalty does not apply when the transaction has been disclosed to the Canada Revenue Agency (CRA) under the reportable transactions rules (whether on an optional or a mandatory basis).

The proposed GAAR amendments are subject to a consultation period, which closes on May 31, 2023. Following the consultation period, the government intends to publish revised legislative proposals and announce the effective date of the amendments.

Denial of the Dividend-Received Deduction for Financial Institutions

The Act already includes numerous measures intended to limit the benefit of the DRD for financial institutions. Budget 2023 now states that the tax treatment of dividends received by financial institutions on portfolio shares is inconsistent with the tax treatment of gains on those shares under the mark-to-market rules. To this end, Budget 2023 proposes to deny the DRD in respect of all dividends received by financial institutions on shares that are mark-to-market property.

Intergenerational Business Transfers

Bill C-208 introduced changes to section 84.1 to facilitate intergenerational transfers. Budget 2023 proposes to amend the rules introduced by the bill to amend perceived deficiencies and ensure that only "genuine" intergenerational business transfers are excluded from the application of section 84.1.

In general, a "genuine" intergenerational business transfer would include a transfer that meets the following conditions:

- An individual (Transferor) transfers shares of a corporation (Transferred Corporation) to another corporation (Purchaser Corporation).

- Each share of the Transferred Corporation is a "qualified small business corporation share" or a "share of the capital stock of a family farm or fishing corporation."
- The Purchaser Corporation is controlled by one or more persons, each of whom is an adult "child" of the Transferor, which, for these purposes, would include grandchildren, step-children, children-in-law, nieces and nephews and grandnieces and grandnephews.
- The business transfer meets the conditions of either (i) an immediate intergenerational business transfer (three-year test) based on arm's-length terms, or (ii) a less stringent gradual intergenerational business transfer (five- to 10-year test) based on traditional estate-freeze characteristics.
- Among other requirements, the three-year test requires the Transferor to transfer both legal and factual control immediately, with the balance of the shares being transferred over three years. The transferee must retain control and remain involved in the business for at least three years after the transfer is completed.
- The five- to 10-year test requires an immediate transfer of legal control with a significant reduction in the Transferor's equity within 10 years. The transferee must retain control and remain involved in the business for the later of five years or the date the business in transferred.

The Transferor and child(ren) must jointly elect for the transfer to qualify as either an immediate or a gradual intergenerational share transfer. The child(ren) would be jointly and severally liable for any additional taxes payable by the Transferor, as per section 84.1 applying. The joint election and joint and several liability recognize that the actions of the child(ren) could cause the parent(s) to fail to meet the conditions and be reassessed under section 84.1. No changes were made to the provisions of Bill C-208 that facilitate the split-up of family businesses under the "butterfly" rules.

The limitation period for reassessing the Transferor's liability for tax that may be due on the transfer is proposed to be extended by three years for an immediate business transfer and by 10 years for a gradual business transfer for the stated purpose of providing the CRA with the ability to monitor compliance with these conditions and to assess taxpayers that do not comply.

Budget 2023 also proposes to provide a 10-year capital gains reserve for business transfers that satisfy the proposed conditions. These measures would apply to transactions that occur on or after January 1, 2024.

Tax on Repurchases of Equity

Budget 2023 introduces a 2% tax on the net value of equity repurchases made by publicly traded businesses, which was initially announced in the 2022 Fall Economic Statement.

The proposed tax generally applies to "covered entities", being (i) publicly traded Canadian resident corporations (other than a mutual fund corporation), (ii) real estate investment trusts or specific investment flow-through (SIFT) trusts, and (iii) SIFT partnership.

The tax would apply to the amount by which the fair market value of equity redemptions, acquisitions and cancellations made by a covered entity in a taxation year exceeds the fair market value of equity issued by the covered entity from treasury in the year. For the purposes of this calculation, equity acquired by certain affiliates of the covered entity may be deemed a repurchase of equity by the entity itself.

Excluded from the tax base calculation are

- "substantive debt," which generally includes preferred shares that are non-convertible or exchangeable, that are non-voting and that have fixed dividend and redemption entitlements, and

- equity that is redeemed, acquired, cancelled or issued in the course of a "reorganization or acquisition transaction," which is generally defined as follows:
  - in the case of an equity issuance, any equity issuance by a covered entity other than (i) an issuance made solely for cash consideration, and (ii) an issuance made to an employee of the covered entity in the course of the employee's employment; and
  - in the case of an equity redemption, acquisition or cancellation, an equity-for-equity exchange whereby no cash consideration is paid, a wind-up, an amalgamation whereby no cash consideration is paid to equity holders of the predecessor entities, and a divisive reorganization carried out under paragraph 55(3)(a) or (b) of the Act.

The proposed tax on equity repurchases is intended to apply to transactions that occur after 2023.

Flow-Through Shares and Critical Mineral Exploration Tax Credit: Lithium from Brines

Budget 2023 proposes to amend the Act to include lithium from brines as a mineral resource. This would allow relevant principal-business corporations that undertake certain exploration and development activities to issue flow-through shares and renounce expenses to their investors. Eligible expenses related to lithium from brines made after March 28, 2023, would qualify as Canadian exploration expenses or Canadian development expenses.

Budget 2023 also proposes to expand the eligibility of the critical mineral exploration tax credit (CMETC) to lithium from brines. The expansion of the eligibility for the CMETC to lithium from brines would apply to flow-through share agreements entered into after March 28, 2023, and before April 2027.

Clean Technology Tax Incentives

Budget 2023 proposes to introduce a refundable investment tax credit for clean technology manufacturing and processing and critical mineral (lithium, cobalt, nickel, graphite, copper and rare earth elements) extraction and processing, equal to 30% of the capital cost of eligible property associated with eligible activities. Eligible property would generally include machinery and equipment, including certain industrial vehicles used in manufacturing, processing or critical mineral extraction, as well as related control systems. Eligible activities includes the manufacturing of certain renewable energy equipment (such as solar, wind, water or geothermal) and the manufacturing of nuclear energy equipment. The tax credit would apply to eligible property acquired and that becomes available for use on or after January 1, 2024.

Budget 2023 also extends and provides further detail on various refundable clean energy investment tax credits and incentives, which were announced in the 2022 Fall Economic Statement and prior budgets, including details on the "labour requirements".

These measures are largely a response to U.S. incentives announced in the *Inflation Reduction Act*.

International Tax Measures

OECD Pillars Updates

Budget 2023 contains an update on Canada's implementation of the OECD-led of Pillars International Tax Reform proposals.

In general, Pillar One is intended to reallocate a portion of taxing rights over the profits of multinational enterprises (MNEs) to market countries (i.e., where their users and customers are located) and Pillar Two is intended to ensure that the profits of MNEs are subject to an effective tax rate of at least 15%, regardless of where they are earned.

It remains the government's hope and underlying assumption that the multilateral negotiations to implement Pillar One can be signed by mid-2023, with a view to it entering into force in 2024. The previously announced Digital Services Tax (DST) could be imposed as of January 1, 2024, if the multilateral convention implementing the Pillar One framework has not come into force.

The primary charging rule under Pillar Two is the Income Inclusion Rule (IIR) whereby the jurisdiction of the ultimate parent entity of an MNE generally has the right to impose a top-up tax on the ultimate parent entity in respect of income from the MNE's operations in any jurisdiction where it is taxed at an effective tax rate below 15%. Pillar Two also contains a "backstop" rule, known as the Undertaxed Profits Rule (UTPR). If a parent jurisdiction of an MNE has not implemented the IIR, other jurisdictions in which the MNE operates, which have implemented the UTPR, would impose the top-up tax on the group entities located in their jurisdiction, allocated among those jurisdictions on a formulary basis.

Consistent with the announcement in Budget 2022, Budget 2023 announces the government's intention to introduce legislation implementing the IIR and a domestic minimum top-up tax applicable to Canadian entities of MNEs that are within scope of Pillar Two. These rules will come into effect for MNE fiscal years that begin on or after December 31, 2023. The government also intends to implement the UTPR with effect for MNE fiscal years that begin on or after December 31, 2024. For these purposes, a MNE fiscal year is considered to be the fiscal year of its ultimate parent entity.

Budget 2023 announced that 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 date. The draft implementing legislation will take into account the comments received in the public consultation on Pillar Two that was announced in Budget 2022. The government intends that the draft legislation closely follow the detailed model rules, the commentary on the model rules and the administrative guidance agreed upon by the OECD's Inclusive Framework, including the application of all agreed safe harbours. The government stated that it will continue to monitor international developments as it moves forward with the implementation of Pillar Two.

Personal Income Tax Measures

Changes to the Alternative Minimum Tax

The AMT is a parallel tax calculation that permits fewer deductions, exemptions and tax credits than under the ordinary income tax rules. The AMT currently applies at a flat rate of 15% with a basic exemption of C$40,000.

Taxpayers are required to pay the greater of their ordinary income tax and the AMT for the year. Additional tax paid under the AMT can generally be carried forward for seven years and can be credited against ordinary income tax to the extent that a taxpayer's ordinary income tax exceeds the AMT in those years.

Budget 2023 proposes to amend and expand the AMT. In particular, the government proposes to increase the federal AMT rate from 15% to 20.5% and to increase the basic exemption from C$40,000 to the minimum threshold for the fourth federal tax bracket. If the provinces make corresponding changes to their AMT rules, the combined federal and provincial AMT rate will likely be in the high 20% to mid 30% range depending on an individual's province of residence. The government states that, on the basis of expected indexation, the basic exemption for 2024 is expected to be approximately C$173,000. The basic exemption would be indexed to inflation annually.

While the Budget 2023 does not change the capital gains inclusion rate or the taxation of stock options, the AMT changes could adversely affect individuals who realize capital gains or stock option benefits.

According to the government, the amendments to the AMT are expected to result in 99% of the AMT paid by individuals to be paid by those who earn more than C$300,000 per year. About 80% of the AMT would be paid by those who earn more than C$1 million per year. The amendments are expected to generate an estimated C$3 billion over a five-year period. The proposed amendments to the AMT are scheduled to come into force for tax years that begin after 2023.

Introduction of Employee Ownership Trusts

An EOT is a form of employee ownership whereby a trust holds shares of a corporation for the benefit of the corporation's employees. EOT legislation was enacted in the United States and the United Kingdom and can be used to facilitate the purchase of a business by its employees without requiring the employees to pay directly to acquire shares.

Budget 2023 proposes new rules to facilitate the establishment of EOTs and the use of EOTs to acquire and hold shares of a business. Generally speaking, an EOT is a factually Canadian resident trust the only purposes of which is to hold shares of “qualifying businesses” for the benefit of employee beneficiaries and to make distributions to employees. All beneficiaries must be employees of the qualifying business and distributions must be made according to a formula that only takes into consideration an employee’s length of service, remuneration or hours worked or otherwise treats all employee beneficiaries equally.

The EOT must directly or indirectly hold a controlling interest in, and all or substantially all, of its assets must consist of one or more “qualifying businesses”. The requirements for qualifying business status generally follow the existing requirements for “small business corporation” status under the Act and also require that certain additional control and relationship tests are satisfied to ensure that the former business owner has truly ceded control of the business to the trust.

All of the trustees of an EOT must be Canadian residents (excluding deemed residents) and must be elected by the beneficiaries at least once every five years. Each trustee must have an equal vote in the conduct of the affairs of the trust. Certain restrictions apply to preclude the former owner of a qualifying business and related persons from representing a majority of the trustees.

EOTs would generally be subject to the same rules as other personal trusts. Accordingly, undistributed trust income would be taxed in the EOT at the highest personal marginal tax rate and trust income distributed by an EOT to its beneficiaries would generally be taxable in the hands of the beneficiaries. If the EOT distributes dividends received from a qualifying business, the dividends should retain their character when received by employee beneficiaries and therefore be eligible for the dividend tax credit. However, an EOT is prohibited from distributing shares of a qualifying business to any beneficiary.

Budget 2023 also proposes to amend various rules in the Act to facilitate the establishment of EOTs, including

- extending the permitted repayment period under the shareholder loan rules to 15 years in respect of debts incurred by an EOT to facilitate the acquisition of a qualifying business;
- extending the five-year period for capital gains reserves to 10 years in respect of a “qualifying business transfer” to an EOT. Generally speaking, a qualifying business transfer involves a disposition of shares to an EOT or a CCPC that is wholly owned and controlled by an EOT with whom the vendor deals at arm’s length. Additional requirements are also imposed to ensure that the vendor remains at arm’s length at all times after the qualifying business transfer and does not retain any direct or indirect influence following the transfer; and
- exempting EOTs from the 21-year deemed disposition rule that applies to certain trusts.

These amendments are scheduled to come into force on January 1, 2024.

Previously Announced Measures

Budget 2023 confirms the government’s intention to proceed with previously announced legislative proposals (as modified to take into account consultations and deliberations since their release), including those relating to the following tax measures:

- excessive interest and financing expenses limitations;
- substantive Canadian-controlled private corporations;
- mandatory disclosure rules (which include “reportable transactions” and “notifiable transactions”); and
- hybrid mismatch arrangements.

Updated legislation for these measures is expected later this year.

In addition, Budget 2023 reaffirms the government's intention to proceed with the transfer pricing consultation announced in Budget 2021 and its commitment, more generally, to move forward with other technical amendments "to improve the certainty and integrity of the tax system."

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