

2023 Federal Budget Review

Finance Minister Chrystia Freeland presented her third Budget in the House of Commons on March 28, 2023, entitled “A Made-in-Canada Plan for a Strong Middle Class, Affordable Economy and Healthy Future”.

In the context of a slowing global economy, elevated interest rates and high inflation, the Finance Minister’s stated goals in introducing Budget 2023 are to provide targeted inflation relief for the most vulnerable Canadians, strengthen public health and dental care, and build Canada’s clean economy – within the context of a responsible fiscal plan. The Budget anticipates a deficit of \$43B for fiscal 2022–23, with gradually reduced deficits thereafter.

Amongst several targeted affordability measures such as an enhanced GST credit (termed a “Grocery Rebate”), reducing “Junk Fees” (such as higher telecom roaming charges), attacking predatory lending rates, and support for students, the government introduced some relieving measures for registered plans, expanded and introduced several new green energy investment tax credits, and provided details on the anticipated share buyback tax.

From a personal and small business tax perspective, which is the focus of this review, the Budget did not introduce any broad-based tax increases, nor any changes to capital gains inclusion rates. However, as expected Budget 2023 introduced significant changes to the Alternative Minimum Tax regime which seeks to ensure that high-income Canadians cannot artificially reduce their tax liability through excessive use of deductions or credits, with the stated goal of generating an estimated \$3B in additional tax revenues over five years, beginning in 2024. For Canadian-Controlled Private Companies (“CCPCs”), significant measures include the introduction of tax changes to facilitate the creation of Employee Ownership Trusts – to encourage greater employee ownership of businesses and provide an alternative exit option for business owners – and clarifying amendments to the recently-enacted tax legislation facilitating “genuine” inter-generational transfers of family businesses.

As in prior years, the Budget proposes additional measures that seek to improve the fairness and transparency of the tax system, most notably the introduction of proposed legislative changes to modernize and strengthen the General Anti-Avoidance Rule to ensure its continued effectiveness. Notably, there were no significant measures in Budget

2023 directly impacting Charities (although it is likely that the changes to AMT could affect some donors).

The most significant income tax measures affecting individuals and Canadian private companies are summarized below. **Note that the measures introduced are only proposals at this stage and may not ultimately be enacted into law as described or at all. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.**

Summary of Personal Income Tax Proposals

Grocery Rebate

Budget 2023 proposes targeted inflation relief by introducing a one-time “Grocery Rebate”, providing \$2.5B to low and modest income Canadians delivered through the Goods and Services Tax Credit (GST Credit) mechanism, which will be delivered as soon as possible following the passage of legislation.

Alternative Minimum Tax

As initially highlighted in its 2021 Election Platform, the Liberal government is seeking to ensure that high income earners pay (Federal) income tax at a rate of at least 15% each year and cannot artificially reduce their taxable income through excessive use of deductions or credits. The Alternative Minimum Tax (“AMT”) is a parallel tax calculation that calculates an alternate taxable income that allows fewer deductions, exemptions, and tax credits than under the ordinary income tax rules, and that currently applies a flat 15% tax rate on this adjusted taxable income (with a standard \$40,000 exemption amount) instead of the usual progressive rate structure. A taxpayer ultimately pays the AMT or regular tax, whichever is highest. Additional tax paid as a result of the AMT can generally be carried forward for seven years and can be credited against regular tax to the extent regular tax exceeds AMT in those years. The AMT does not apply in the year of death.

Last year's Federal Budget announced the government's commitment to examine a new minimum tax regime and Budget 2023 proposes several changes to its calculation, with the stated goal of better targeting high-income individuals. Key design features of the new AMT regime are highlighted below with the intention of broadening the AMT base, further limiting tax preference items (i.e., exemptions, deductions and credits) and increasing the AMT tax rate. Additional details are to be released later this year.

Capital Gains and Stock Options

Budget 2023 proposes to increase the AMT capital gains inclusion rate from 80% to 100%. However, capital loss carry forwards and allowable business investment losses would apply at a 50% rate. It is also proposed that 100% of the benefit associated with employee stock options would be included in the AMT base.

Lifetime Capital Gains Exemption

Under current rules, 30% of capital gains eligible for the lifetime capital gains exemption are included in the AMT base. Budget 2023 does not propose to alter this treatment.

Donation of Publicly Listed Securities

Currently, 100% of the capital gain realized on the donation of publicly listed securities to qualified donees is exempted from tax. The government proposes to include 30% of capital gains realized on donations of publicly listed securities in the AMT base, mirroring the above AMT treatment of capital gains eligible for the lifetime capital gains exemption. The 30% inclusion would also apply to the full benefit associated with employee stock options to the extent that a deduction is available because the underlying securities are publicly listed securities that have been donated.

Select Deductions and Expenses

Under these new rules proposed, the AMT base would be broadened by disallowing 50% of a number of deductions. The following is not exhaustive, but a list of some common deductions that will be affected:

- Employment expenses, other than those to earn commission income;
- Moving expenses;
- Child care expenses;
- Interest and carrying charges incurred to earn income from property;
- Deduction for limited partnership losses of other years; and
- Non-capital loss carryovers.

Non-refundable Credits

Currently, most non-refundable tax credits can be credited against the AMT. However, Budget 2023 proposes that only 50% of non-refundable tax credits would be allowed to reduce the AMT, subject to some exceptions, including the continued full disallowance of the Dividend Tax Credit under the current legislation [and the continued use of the cash (i.e., not grossed-up) value of dividends].

Raising the AMT Exemption

The exemption amount is a deduction available to all individuals (excluding trusts, other than graduated rate estates) that is intended to protect lower and middle-income individuals from the AMT. Budget 2023 proposes to increase the exemption from \$40,000 to the start of the fourth Federal tax bracket. Based on expected indexation for the 2024 taxation year, this exemption would be approximately \$173,000, and would be indexed annually to inflation.

Increasing the AMT Tax Rate

Budget 2023 proposes to increase the AMT rate from 15% to 20.5%, corresponding to the rates applicable to the first and second Federal income tax brackets, respectively.

Notably, the length of the carryforward period to apply the AMT tax paid to future years would be maintained at seven years and trusts that are currently exempt from AMT would continue to be exempt (while the government examines whether additional types of trusts should be exempted).

These proposed changes would come into force for taxation years that begin after 2023.

Other Personal Tax Measures

Automatic Tax Filing

Budget 2023 also announces that, starting next year, the Canada Revenue Agency ("CRA") will pilot a new automatic filing service that will help vulnerable Canadians who currently do not file their taxes receive the benefits to which they are entitled. Following consultations with stakeholders and community organizations, the CRA will present a plan in 2024 to expand this service further.

Tradespeople's Tool Deduction

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

Measures Affecting Registered Plans

Registered Educational Savings Plans

Registered Education Savings Plans (“RESPs”) are tax-assisted savings vehicles designed to help families accumulate savings for the post-secondary education of their children. When an RESP beneficiary is enrolled in an eligible post-secondary program, any government grants received and investment income earned can be withdrawn from the plan as (taxable) Educational Assistance Payments (“EAPs”) in order to assist with post-secondary education-related expenses.

Budget 2023 proposes to permit EAP withdrawals of up to \$8,000 (from \$5,000) in respect of the first 13 consecutive weeks of enrollment for beneficiaries enrolled in full-time programs, and up to \$4,000 (from \$2,500) per 13-week period for beneficiaries enrolled in part-time programs.

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. Previously, only spouses or common-law partners could jointly enter into an agreement with an RESP promoter to open an RESP.

Both of these changes are effective as of Budget Day.

Registered Disability Savings Plans

Registered Disability Savings Plans (“RDSPs”) are designed to support the long-term financial security of a beneficiary who is eligible for the disability tax credit. The Federal government has previously expanded access to RDSPs by allowing a qualifying family member – such as a parent, a spouse, or a common-law partner – to open an RDSP and be the plan holder for an adult with mental disabilities whose ability to enter into an RDSP contract is in doubt, and who does not have a legal representative. This provision has helped many families access an RDSP, but it is currently set to expire.

Accordingly, Budget 2023 announces the government’s intention to extend the Qualifying Family Member provision until December 31, 2026 and to expand the provision to include adult siblings of an RDSP beneficiary.

Retirement Compensation Arrangements

A Retirement Compensation Arrangement (“RCA”) is a type of employer-sponsored arrangement that generally allows an employer to provide supplemental pension benefits to employees.

Employers who do not pre-fund supplemental retirement benefits through contributions to an RCA trust, and instead settle retirement benefit obligations as they become due, typically obtain a letter of

credit (or a surety bond) issued by a financial institution in order to provide security to their employees. However, the annual fee or premium charged by the issuer are subject to the 50% refundable tax applicable to RCAs.

In order to provide a practical mechanism for recovery of this refundable tax, Budget 2023 proposes to amend the Income Tax Act so that fees or premiums paid for the purposes of securing or renewing a letter of credit (or a surety bond) for an RCA will not be subject to the refundable tax, effective for fees or premiums paid on or after Budget Day.

Effective for RCA retirement benefits paid after 2023, Budget 2023 also proposes to allow employers to request a refund of previously remitted refundable taxes in respect of fees or premiums paid for letters of credit (or surety bonds) by RCA trusts.

Proposals Affecting Canadian Private Companies

Employee Ownership Trusts

An Employee Ownership Trust (“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 purchase of a business by its employees, without requiring them to pay directly to acquire shares. For business owners, an EOT can also provide an additional option for succession planning.

Previous Federal budgets outlined the government’s intention to engage with stakeholders through a consultation process to address barriers that existed in the current tax legislation, which lacked a dedicated trust vehicle tailored to facilitate employee ownership and/or the transition of a privately-owned business to its employees.

Budget 2023 proposes to introduce new tax rules to facilitate the creation and use of EOTs to acquire and hold shares of a business. The new rules would define qualifying conditions to be an EOT and propose changes to other tax rules to facilitate the establishment of EOTs. These amendments would apply as of January 1, 2024.

Qualifying Conditions

The following qualifying conditions and general rules would apply to EOTs:

Definitions

A trust would be considered an EOT if it is a Canadian resident trust (excluding deemed resident trusts) and has 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 *qualifying employee beneficiaries*, where reasonable, under a distribution formula that could only consider an employee's length of service, remuneration, and hours worked.

An EOT would be required to hold a controlling interest in the shares of one or more qualifying businesses. All or substantially all of an EOT's assets must be shares of qualifying businesses.

Qualifying business – A qualifying business would need to meet certain conditions, including that it is a CCPC where all or substantially all of the fair market value of its assets are attributable to assets that are used principally in an active business carried on primarily in Canada.

Qualifying employee beneficiaries – Beneficiaries of the trust must consist exclusively of qualifying employees. Qualifying employees would include all individuals employed by a qualifying business and any other qualifying businesses it controls, with the exclusion of employees who are significant economic interest holders, or have not completed a reasonable probationary period of up to 12 months. Individuals (and related persons) who hold, or held prior to the sale to an EOT, a significant economic interest in a qualifying business of the EOT would also be excluded from being qualifying employees.

Governance

The trustees, including corporations that serve as trustees, would be required to be Canadian residents (excluding deemed residents). Trust beneficiaries (ages 18 and older) would elect the trustees at least once every five years. When an existing business is sold to an EOT, individuals (and their related persons) who held a significant economic interest in the existing business prior to the sale would not be able to account for more than 40% of:

- the trustees of the EOT;
- directors of the board of a corporation serving as a trustee of the EOT; or
- directors of any qualifying business of the EOT.

Tax Treatment

The EOT would be a taxable trust and would therefore generally be subject to the same rules as other personal trusts. Undistributed trust income would be taxed in the EOT at the top personal marginal tax rate, whereas trust income distributed from an EOT to its beneficiaries would not be subject to tax at the trust level but at the beneficiary level. If the EOT distributes dividends received from qualifying businesses, those dividends would retain their character when received by employee beneficiaries and would therefore 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 no more than 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 wholly-owned by the EOT. The EOT must own a controlling interest in the qualifying business immediately after the qualifying business transfer.

Facilitating the Establishment of EOTs

To better accommodate the establishment and use of EOTs, certain existing tax rules would be modified, as follows:

Ten-Year Capital Gains Reserve

Since it is anticipated that sales to an EOT could have an extended period of deferred consideration, Budget 2023 proposes to extend the existing five-year capital gains reserve to a ten-year reserve for qualifying business transfers to an EOT. A minimum of 10% of the gain would be required to be brought into income each year, creating a maximum ten-year deferral period. All individuals who disposed of shares in a qualifying business transfer would be eligible to claim the proposed expanded capital gains reserve.

Exception to Shareholder Loan Rules

Taxpayers who receive a shareholder loan are generally required to include the loaned amount in income in the year the loan is received, unless the loan is repaid within a year. Under current legislation, if an EOT were to borrow from a qualifying business to finance the purchase of shares in a qualifying business transfer, the EOT would be required to repay borrowed amounts within one year of the qualifying business' taxation year end to avoid paying taxes on the loaned amount.

Budget 2023 therefore proposes to introduce a new exception to these shareholder loan rules to extend the repayment period from one to 15 years for amounts loaned to the EOT from a qualifying business to purchase shares in a qualifying business transfer.

Exception to 21-year rule

To prevent the indefinite deferral of tax on accrued capital gains, certain trusts are deemed to dispose of their capital property at 21-year intervals. Since an EOT is intended to allow for shares to be held indefinitely for the benefit of employees, Budget 2023 proposes to exempt EOTs from the 21-year rule. If a trust no longer meets the conditions to be considered an EOT, the 21-year rule would be reinstated until the trust next meets the EOT conditions.

Intergenerational Transfers of Family Businesses

The Canadian tax legislation contains a number of anti-avoidance tax measures such as those which seek to prevent corporate “surplus stripping,” aimed at achieving neutrality and integration in the tax system, by ensuring that income earned directly by a Canadian-resident individual is taxed at roughly the same rate as income that is earned first through a corporation and then distributed to the individual shareholder. Specifically, these anti-avoidance rules would typically apply to convert a capital gain into a taxable dividend (which is subject to a higher tax rate than a capital gain, and ineligible for the lifetime capital gains exemption) when an individual transfers shares of their corporation to a related party corporation. As a result, the application of these anti-avoidance rules has historically created a higher tax cost on the intergenerational transfer of a business to a family member versus a sale to a third-party purchaser. In recognition of this long-standing imbalance in the tax treatment of family business sales/transitions, private members’ Bill C-208 was introduced and received Royal Assent on June 29, 2021. This recently-enacted legislation seeks to limit the application of the aforementioned anti-avoidance rule in the case of certain intergenerational transfers of shares from parents to corporations owned by their children (or grandchildren) to ensure favourable capital gains tax treatments are realized on such transfer or sale of shares.

Although the stated purpose of Bill C-208 was to facilitate intergenerational business transfers in circumstances where anti-avoidance rules inappropriately applied, the Federal Government previously identified that rules introduced by Bill C-208 contain insufficient safeguards and are available where no transfer of a business to the next generation has taken place. More specifically, the amendments introduced by Bill C-208 do not require that:

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

As a result of these concerns, Budget 2023 proposes to amend the rules introduced by Bill C-208 to ensure that they apply only where a “genuine” intergenerational business transfer takes place.

A genuine intergenerational share transfer would be a transfer of shares of a corporation (the Transferred Corporation) by an individual (the Transferor) to another corporation (the Purchaser Corporation) where a number of conditions are satisfied.

The following existing conditions would be maintained:

- 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; and
- 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, step-children, children-in-law, nieces and nephews, and grandnieces and grandnephews).

To ensure that only genuine intergenerational share transfers are excluded from the application of the above anti-avoidance rules, additional conditions are proposed to be added. To provide flexibility, it is proposed that taxpayers who wish to undertake a genuine intergenerational share transfer may choose to rely on one of two transfer options:

1. An immediate intergenerational business transfer (3 year test) based on arm’s length sale terms; or
2. A gradual intergenerational business transfer (5-10 year test) based on traditional estate freeze characteristics.

The immediate transfer rule would provide finality earlier in the process, though with more stringent conditions, whereas the gradual transfer rule would provide additional flexibility.

Budget 2023 outlines the proposed conditions in detail under each of the two transition methods, both of which are intended to reflect the hallmarks of a genuine intergenerational business transfer. Budget 2023 proposes the following conditions, and outlines the differences between each of the two methods:

- Transfer of control of the business – identifying when legal and factual control is required to be transferred to family members;
- Transfer of economic interests in the business – required timing on transfer of common growth shares and reduction of parent’s economic interest in the business;
- Transfer of management of the business – by parents to their child(ren);
- Child retains control of the business – the length of time required for the next generation of family members to retain legal control of the business; and
- Child works in the business – outlining the required amount of time a child must be actively involved in the business following the share transfer.

The Transferor and child (or children) would be required to jointly elect for the transfer to qualify as either an immediate or gradual intergenerational share transfer. Recognizing that the actions of the child(ren) could potentially cause the parent to fail the conditions and to be reassessed for taxes owing, the child(ren) would be jointly and severally liable for any additional taxes payable by the Transferor, because of any anti-avoidance rules applying, in respect of a transfer that does not meet the above conditions.

Furthermore, limitation periods for reassessing a Transferor's tax liability that may arise on the transfer are proposed to be extended by 3 years for an immediate business transfer, and by 10 years for a gradual transfer, to provide CRA the ability to monitor compliance with the proposed conditions on genuine business transfers.

Lastly, Budget 2023 also proposes to provide a ten-year capital gains reserve for genuine intergenerational share transfers that satisfy the above conditions.

All proposed measures would apply to transactions that occur on or after January 1, 2024.

Other Corporate Measures

Lower Credit Card Fees

To support small businesses, the Federal government announced in Budget 2023 that it has secured commitments from the payment card industry to lower the "interchange fees" paid to credit card issuers.

Share Buyback Tax

As originally announced in the 2022 Fall Economic Statement, Budget 2023 proposes a 2% tax on share buybacks by public corporations in Canada to apply as of January 1, 2024 to the annual net value of repurchases of equity by public corporations and certain publicly traded trusts and partnerships in Canada, with an annual exception for a year where its gross repurchases of equity were less than \$1MM.

Investment Tax Credits for Clean Technology

Budget 2023 provides further details on new Investment Tax Credits for clean technology originally introduced in the 2022 Fall Economic Statement, namely the Clean Hydrogen Investment Tax Credit and Clean Technology Investment Tax Credit, expands the Carbon Capture, Utilization, and Storage ("CCUS") Investment Tax Credit announced in Budget 2022, and introduces two additional new ITCs:

- Clean Electricity Investment Tax Credit – a 15% refundable tax credit to support and accelerate clean electricity investment in Canada; and

- Clean Technology Manufacturing Investment Tax Credit – a 30% refundable tax credit for investments in new machinery and equipment used to manufacture or process key clean technologies, and extract, process, or recycle key critical minerals.

Review of the Scientific Research and Experimental Development Tax Incentive Program

The Scientific Research and Experimental Development ("SR&ED") program incents Canadian businesses to invest in innovation that drives economic growth. In Budget 2022, the Federal government announced its intention to review the SR&ED program to ensure it is providing adequate support and improving the development, retention, and commercialization of intellectual property, including the consideration of adopting a patent box regime. The Department of Finance announced in Budget 2023 that it will continue to engage with stakeholders on the next steps in the coming months.

Other Notable Measures

As in previous budgets, Budget 2023 continues the government's efforts to make legislative adjustments to help ensure that the tax system is functioning as intended and introduces certain measures to maintain the fairness and integrity of the tax system, most notably to the General Anti-Avoidance Rule, as follows:

Strengthening the General Anti-Avoidance Rule

The General Anti-Avoidance Rule ("GAAR") was added to the Income Tax Act in 1988 to prevent abusive tax avoidance. If abusive tax avoidance is established, the GAAR applies to deny the tax benefit that was unfairly created. In previous Budgets, the government has expressed the need to modernize and strengthen the GAAR to ensure its continued effectiveness.

Taking into account stakeholder feedback from recent public consultations, Budget 2023 proposes to amend the GAAR by: introducing a preamble to address interpretive issues; changing the "avoidance transaction" standard from a "primary purpose" test to a "one of the main purposes test"; introducing an "economic substance" rule; introducing a penalty for transactions subject to the GAAR; and extending the reassessment period in certain circumstances.

The government indicated that it will be seeking stakeholders' views on these proposals until May 31, 2023 and will publish revised legislative proposals and announce the application date of the amendments, following this period of consultation.

Previously Announced Measures

Finally, Budget 2023 confirms the government's intention to proceed with many previously announced tax and related measures that have not yet been formally enacted, including the following notable measures affecting individuals and Canadian private companies:

- Reporting Requirements for Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs);
- Substantive Canadian-Controlled Private Corporations;
- Mandatory Disclosure Rules; and
- The Electronic Filing and Certification of Tax and Information Returns.

Budget 2023 also reaffirmed the government's commitment to move forward as required with other technical amendments to improve the certainty and integrity of the tax system.

The **2023 Federal Budget Review** was developed by our in-house tax professionals in the Wealth Planning and Advisory Services Group at BMO Private Wealth; **John Waters**, Vice-President, Director of Tax Consulting Services and **Dante Rossi**, Director, Tax Planning. For more insights, visit bmo.com/wealthinsights

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details.

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