2023 Federal Budget: Top 4 Changes for Tax Planning

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On March 28, 2023, Canada's Deputy Prime Minister and Finance Minister, the Honourable Chrystia Freeland, presented the new federal budget ("Budget 2023"). While the primary focus of Budget 2023 was the introduction of new ways to develop Canada's green economy, the yearly budget commonly includes changes to Canadian tax policy that are relevant for both tax practitioners and taxpayers alike. Importantly, Budget 2023 made no changes to personal or corporate tax rates, or the inclusion rate on taxable capital gains. Therefore, transactions that rely on these tax rates (i.e. transactions that permit a taxpayer to draw funds from their corporation at lower capital gain rates instead of high dividend or salary rates) remain status quo.

Our top four key takeaways for tax planning from Budget 2023 are:

1. ALTERNATIVE MINIMUM TAX FOR HIGH INCOME INDIVIDUALS

Alternative Minimum Tax ("AMT") is a Canadian tax policy which mandates that all individuals are responsible for paying a minimum tax amount, notwithstanding that the use of deductions may reduce their tax beyond the minimum. This provision requires individuals to calculate their taxable income twice: (1) to calculate their regular tax; and (2) to determine whether they are subject to AMT. If an individual's taxes are below the AMT amount, the person will be required to pay the AMT amount.

AMT is currently calculated by determining one's "adjusted taxable income" which is calculated by taking net taxable income and adjusting for certain "tax preference items" such as tax shelter deductions, interest expenses, and the lifetime capital gains deduction, among others. Adjusted taxable income is then reduced by a standard $40,000.00 exemption and multiplied by a tax rate of 15% before a final deduction of certain non-refundable tax credits

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to arrive at the AMT amount. The taxpayer will then pay the AMT or regular tax amount, whichever is highest.

In order to better target high-income individuals, Budget 2023 has proposed to amend the AMT as follows:

1. Increasing the federal AMT rate from 15% to 20.5%;
2. Increasing the exemption amount for all individuals from $40,000.00 to the start of the fourth federal tax bracket (approximately $173,000.00 for the 2024 tax year);
3. Broadening the AMT base by further limiting tax preferences as follows:
    a. Increasing the capital gains inclusion rate from 80% to 100%;
    b. Applying a 50% rate to capital loss carry forwards and allowable business investment losses;
    c. Including 30% of the capital gains on donations of publicly listed securities;
    d. Including 100% of the benefit associated with employee stock options;
    e. Disallowing 50% of certain deductions; and
    f. Allowing only 50% of most non-refundable tax credits to reduce the AMT.

Additional details on these amendments will be released later this year and the government will continue to consider whether other types of trusts should be exempt from AMT.

The proposed changes would come into effect for taxation years that begin after 2023.

2. BILL C-208 – INTERGENERATIONAL BUSINESS TRANSFERS

Bill C-208, which first came into effect on June 29, 2021, was originally introduced as an exception to the anti-surplus stripping rules in section 84.1 of the *Income Tax Act* (Canada). Its main purpose was to facilitate intergenerational business transfers in circumstances where section 84.1 inappropriately applied; however, the Department of Finance has determined that there are additional criteria in order to determine that a true *bona fide* intergenerational business transfer has occurred.

According to Budget 2023, taxpayers may choose to rely on one of the two following transfer options, provided they meet certain conditions:

1. an immediate intergenerational business transfer (three-year test) based on arm's length sale terms; or
2. a gradual intergenerational business transfer (five-to-ten-year test) based on traditional estate freeze characteristics (an estate freeze typically involves a parent crystalizing the value of their common shares of a corporation into fixed value preference shares to allow future growth to accrue to their children while the value of the parent's interest is gradually reduced by the corporation repurchasing the parent's preference shares).

The above term "gradual" is misleading because in both circumstances the majority of votes must be transferred immediately to the corporation controlled by the child(ren). The only

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relevant distinguishing factor referring to control is that the three-year test requires both transfer control in fact and legal control. The gradual test only requires transfer of legal control. This means that there may be flexibility (i.e. certain outside agreements that limit voting rights) to allow parents to maintain control of the corporation in fact despite not owning a majority of votes.

The transferor and the child(ren) must jointly elect for the transfer to qualify for one of the above-noted options. If the transfer does not meet the conditions to qualify for either option, the child(ren) will be jointly or severally liable for any additional taxes payable by the transferor as a result of section 84.1 being found to apply.

These measures will apply to transactions that occur on or after January 1, 2024. It is strongly encouraged that if you are one of the many business owners that wishes to transfer economic growth of the family without relinquishing control prior to full satisfaction of payment, that you enact the sale *prior* to the introduction of these new changes.

3. THE GENERAL ANTI-AVOIDANCE RULE (GAAR)

The General Anti-Avoidance Rule ("GAAR") was added to the *Income Tax Act* (Canada) in 1988 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 that was created by the abusive transaction.

Budget 2023 proposed draft legislation to modernize and strengthen the GAAR by introducing a preamble, changing the avoidance transaction standard, introducing an economic substance rule, introducing a penalty, and extending the reassessment period in certain circumstances.

1. **Preamble:** A preamble would be added to clarify that the GAAR:
    a. Draws a line that 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;
    b. Is intended to strike a balance between taxpayers' need for certainty in planning their affairs and the government's responsibility to protect taxpayers and the fairness of the tax system; and
    c. Is intended to apply regardless of whether or not the tax planning strategy used to obtain the tax benefit was foreseen.
2. **Avoidance Transaction:** The threshold for the avoidance transaction test in the GAAR would be reduced from a "primary purpose" test to a "one of the main purposes" test.
3. **Economic Substance:** The proposed amendments 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; however, Budget 2023 states that a lack of economic substance will not always mean that a transaction is abusive.
4. **Penalty:** A penalty equal to 25% of the amount of the tax benefit would be introduced for

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transactions subject to the GAAR.
5. **Reassessment Period:** A three-year extension to the normal reassessment period would be provided for GAAR assessments.

While the budget did not directly address the transaction commonly known as a "capital gain strip" which allows a taxpayer to draw funds from their corporation at capital gain tax rates instead of high dividend or salary rates, there is a possibility that the strengthened GAAR may be used to prevent capital gain strips in the future.

A consultation period will close on May 31, 2023, after which the government intends to publish revised legislative proposals and announce the application date of the amendments.

4. 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. Since EOTs can be used to facilitate the purchase of a business by its employees without requiring them to pay directly to acquire shares, EOTs provide 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 new rules would define qualifying conditions to be an EOT and propose changes to tax rules to facilitate the establishment of EOTs.

1. **Qualifying Conditions**: To be an EOT, a trust would need to be resident in Canada and satisfy certain conditions, including but not limited to the following:
    a. The trust holds shares of qualifying businesses for the benefit of the employee beneficiaries;
    b. The trust makes distributions to employee beneficiaries, and generally treats beneficiaries in a similar manner, except where it applies a distribution formula that considers an employee's length of service, remuneration, and hours worked;
    c. The trust holds a controlling interest in the shares of one or more qualifying businesses (defined as a Canadian-controlled private corporation that meets certain conditions, including that all or substantially all of the fair market value of its assets are attributable to assets used in an active business carried on in Canada);
    d. The trustees are Canadian residents, who are elected by the trust beneficiaries at least once every five years; and
    e. The trust beneficiaries must consist exclusively of qualifying employees (defined as 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).
2. **Facilitating the Establishment of EOTs**: To better accommodate the establishment and use of EOTs, certain existing tax rules will be modified:
    a. Currently, taxpayers are permitted to defer recognition of a capital gain until the year they receive proceeds, with a minimum of 20% of the gain brought into income each year. Budget 2023 proposes to extend this five-year capital gains reserve to a ten-year capital gains reserve

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for qualifying business transfers to an EOT;

b. Currently, 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. Budget 2023 proposes 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; and
c. Currently, certain trusts are deemed to dispose of their capital property at 21-year intervals. Budget 2023 proposes to exempt EOTs from the 21-year rule.

While some of Budget 2023's proposals are a "win", there is still more that can be done to facilitate the best use of EOTs. The Canadian Employee Ownership Coalition ("CEOC"), a non-partisan network of Canadians from the business, non-profit, academic and charitable sectors committed to unlocking the potential of employee ownership for the benefit of Canada's economy and workers, has advocated for greater incentives for corporations to consider selling to employees, such as capital gains exemptions. Chad Friesen, CEO of Friesens Corporation and member of the Steering Committee of the CEOC comments that the government has signaled a willingness to continue meeting with the CEOC to hear how to improve the legislation before it becomes law.

The EOT rules will apply as of January 1, 2024.

Conclusion

The above four changes only scratch the surface of Budget 2023.

It is recommended that you **contact one of our TDS Tax Lawyers** to advise how you can navigate and take advantage of post-Budget 2023 tax planning.

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