Cassels

2023 Federal Budget Tax Highlights

March 29, 2023

INTRODUCTION

On March 28, 2023 (Budget Day), the Honourable Chrystia Freeland, Deputy Prime Minister and Finance Minister, delivered the 2023 federal budget titled, “A Made-In-Canada Plan” (Budget 2023).

Budget 2023 contains several significant income tax measures, including:

- Substantial proposals to incentivize green initiatives and investment in clean energy;
- Details on the 2% tax on the net value of repurchases of equity by certain publicly traded entities;
- Extensive changes to the application of the general anti-avoidance rule (GAAR);
- Strengthening the Intergenerational Business Transfer Framework; and
- New rules to facilitate the use of Employee Ownership Trusts (EOTs) to acquire shares of a business.

From an international tax perspective, Budget 2023 confirms Government of Canada (Government) support for establishing the Pillar One and Pillar Two framework of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting.

Although Budget 2023 did not increase the federal corporate or personal tax rates under the *Income Tax Act* (Canada) (Tax Act), increase the capital gains inclusion rate, or make changes to the existing lifetime capital gains exemption, Budget 2023 does propose new changes to broaden the Alternative Minimum Tax (AMT).

The following is a summary of select income tax measures introduced in Budget 2023 that are most relevant to businesses.

BUSINESS INCOME TAX MEASURES

Clean Energy Incentives

Budget 2023 proposes measures to invest heavily in a clean economy in response to the recent passage of

the United States' *Inflation Reduction Act* (IRA). The IRA, which offers significant fiscal incentives relating to clean energy in the United States, poses a challenge to Canada's ability to compete in the industries that will drive Canada's clean economy.

In the 2022 Fall Economic Statement, the Government announced two new refundable tax credits, which would be available for expenditures related to the capital cost of investments in:

- the production of clean hydrogen (Clean Hydrogen ITC); and
- clean technologies (Clean Technology ITC)

where the property becomes available for use on or after Budget Day.

Budget 2023 provides details with respect to these proposed tax credits, introduces additional incentives and expands on existing incentives relating to clean energy, as follows:

- Clean Hydrogen ITC;
- Clean Technology ITC for Geothermal Energy;
- Investment Tax Credit for Clean Technology Manufacturing;
- Clean Electricity Investment Tax Credit (Clean Electricity ITC); and
- Expansion of Carbon Capture, Utilization and Storage Credit (CCUS Tax Credit).

Labour Requirements Relating to Investment Tax Credits

In the 2022 Fall Economic Statement, the Government announced its intention to attach wage and apprenticeship requirements (Labour Requirements) to the proposed Clean Technology ITC and Clean Hydrogen ITC. Budget 2023 proposes that the Labour Requirements also apply to the proposed Clean Electricity ITC and the CCUS Tax Credit.

The Labour Requirements resemble those placed on similar tax credits introduced in the United States under the IRA. The Government will continue to consult with labour unions and other stakeholders to refine the Labour Requirements in the coming months. The Notice of Ways and Means Motion accompanying Budget 2023 defers the release of draft legislation until a future date.

The Labour Requirements must be satisfied in order to access the maximum credits available, as summarized below:

	Labour Requirements Satisfied	**Labour Requirements Not Satisfied**
Clean Technology ITC	30%	20%
Clean Hydrogen ITC	40% (maximum)	30% (maximum)

Clean Electricity ITC	15%	5%

If the applicable tax credit rate is in a phase-out period, it will be reduced by 10% to a minimum of 0%.

Exemptions

Under the Clean Technology ITC, acquisitions of zero-emission vehicles and acquisitions and installations of low-carbon heat equipment are exempt from the Labour Requirements.

Prevailing Wage Requirement

A business would need to ensure that all covered workers (those whose duties correspond to those performed by a journeyperson in a Red Seal trade) are compensated at a level that meets or exceeds the relevant wage, plus the substantially similar monetary value of standard benefits and pension contributions (converted into an hourly wage format) as specified in an "eligible collective agreement". The definition of eligible collective agreement will vary depending on whether workers are governed by a collective bargaining agreement or project labour agreement outside of Québec or within Québec.

A business could meet the prevailing wage requirement by paying workers in accordance with an eligible collective agreement or by paying workers at or above the equivalent prevailing wage. The requirement could be satisfied through different combinations of wages, pension contributions, and benefits.

Apprenticeship Requirement

A business would need to ensure that for a given taxation year not less than 10% of the total labour hours performed by covered workers engaged in subsidized project elements are performed by registered apprentices. Businesses must continue to comply with applicable labour laws and collective agreements to ensure there are no more apprentices working than permitted.

Application

The Labour Requirements would apply in respect of workers engaged in project elements subsidized by the respective investment tax credit, whether they are directly engaged by the business or a contractor or subcontractor. The Labour Requirements would apply to workers whose duties are primarily manual or physical in nature and not to those whose duties are primarily administrative, clerical, supervisory, or executive.

The Labour Requirements would apply to work that is performed on or after October 1, 2023. Since the Clean Technology ITC and the Clean Hydrogen ITC are effective as of Budget Day, the Labour Requirements are not required to be satisfied during the interim period until October 1, 2023.

Corrections and Penalties

Businesses may pay corrective remuneration to workers, including interest, and pay penalties to resolve non-compliance and be deemed to have satisfied the Labour Requirements. Further details on this mechanism will be announced.

Clean Hydrogen Investment Tax Credit

The Clean Hydrogen ITC will be available in respect of expenditures on eligible equipment that is available for use on or after Budget Day. The Clean Hydrogen ITC will be refundable at different rates depending on the carbon intensity of the hydrogen (measured in kilogram (kg) of carbon dioxide (CO_2) equivalent per kg of hydrogen) that is produced, with projects producing the cleanest hydrogen receiving the highest credit:

- 40% for a carbon intensity of less than 0.75 kg;
- 25% for a carbon intensity greater than or equal to 0.75 kg, but less than 2 kg; and
- 15% for a carbon intensity greater than or equal to 2 kg, but less than 4 kg.

The applicable Clean Hydrogen ITC rate will be reduced by 10% where the Labour Requirements are not met.

Budget 2023 provides an overview as to how carbon intensity will be measured and how this measurement is verified at the front end and on an ongoing basis during an "assessment period", but defers the details regarding measurement, verification, and recovery of the Clean Hydrogen ITC to a future date.

For purposes of measuring carbon intensity, carbon emissions will not be counted if they are stored by way of an "eligible use" for purposes of the CCUS Tax Credit. Carbon emissions that are stored or used in other ways (including enhanced oil recovery) will be treated as if they were released into the atmosphere.

Projects eligible for the Clean Hydrogen ITC will be projects that produce all, or substantially all (i.e., 90% or more), hydrogen through their production processes (determined without reference to CO_2 that is captured and stored or used, or excess electricity that may be sold to the grid). The Clean Hydrogen ITC would be available for the cost of eligible equipment from projects that produce hydrogen from electrolysis or natural gas (provided emissions are abated using carbon capture, utilization, and storage (CCUS)). Eligible equipment required to produce hydrogen includes:

- Equipment required to produce hydrogen from electrolysis if all or substantially all of the use of that equipment is to produce hydrogen through electrolysis of water;
- Equipment required to produce hydrogen from natural gas with emissions abated using CCUS, excluding equipment already described in capital cost allowance (CCA) Class 57 or Class 58, which is eligible for the CCUS ITC;

- Oxygen production equipment used for hydrogen production, so long as the resulting CO_2 is captured by a CCUS process;
- Equipment that produces heat and/or power from natural gas or hydrogen; and
- Dual use power or heat production equipment would be eligible only if the energy balance is expected to be primarily used (i.e., more than 50%) to support the CCUS process or hydrogen production that is eligible for the Clean Hydrogen ITC, with the cost of such equipment being pro-rated in proportion to the expected energy balance supporting hydrogen production.

Other expenses that may be related to a hydrogen production project, including feasibility studies, front-end engineering design studies, and operating expenses, would not be eligible for the Clean Hydrogen ITC.

Property that is used to convert clean hydrogen to clean ammonia is eligible for the Clean Hydrogen ITC at the lowest credit rate of 15%.

The Clean Hydrogen ITC will be reduced by 50% in 2034 and will be fully phased out by 2035.

Clean Technology Investment Tax Credit – Geothermal Energy

The Clean Technology ITC was proposed in the 2022 Fall Economic Statement as a 30% refundable investment tax credit and was initially intended to apply to the following types of equipment:

- Electricity generation systems: equipment to generate electricity from solar, wind, and water energy that is described under subparagraphs (d)(ii), (iii.1), (v), (vi) and (xiv) of CCA Class 43.1;
- Stationary electricity storage systems: equipment described under subparagraphs (d)(xviii) and (d)(xix) of Class 43.1, but that does not use any fossil fuels in operation, which includes, but is not limited to, batteries, flywheels, supercapacitors, magnetic energy storage, compressed air energy storage, pumped hydroelectric energy storage, gravity energy storage, and thermal energy storage;
- Low-carbon heat and electricity equipment: including active solar heating equipment, air-source heat pumps, and ground-source heat pumps that are described under subparagraph (d)(i) of Class 43.1; equipment to generate heat or electricity from concentrated solar energy; and equipment to generate heat or electricity from small modular nuclear reactors; and
- Industrial zero-emission vehicles and related charging or refuelling equipment: non-road zero-emission vehicles described in Class 56 (*g.,* hydrogen or electric heavy duty equipment used in mining or construction) and charging or refuelling equipment described under subparagraph (d)(xxi) of Class 43.1 or subparagraph (b)(ii) of Class 43.2 that is used primarily for such vehicles.

The Clean Technology ITC rate will be reduced by 10% where the Labour Requirements are not met.

Budget 2023 expands the Clean Technology ITC to include geothermal energy systems that are eligible for inclusion in CCA Class 43.1. Eligible property will include equipment used primarily (i.e., more than 50%) for

the purpose of generating electrical or heat energy, or both electrical and heat energy, solely from geothermal energy that is described in subparagraph (d)(vii) of Class 43.1. This includes piping, pumps, heat exchangers, steam separators, and electrical generating equipment. The expansion of the Clean Technology ITC will apply to 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.

Geothermal projects that co-produce oil, gas, or other fossil fuels would not be eligible for the Clean Technology ITC.

Budget 2023 modifies the phase-out schedule for the Clean Technology ITC previously announced in the 2022 Fall Economic Statement. The rate will remain at 30% for property that becomes available for use in 2032 and 2033 and will be reduced to 15% for property that becomes available for use in 2034. The credit will not be available after 2034.

Investment Tax Credit for Clean Technology Manufacturing

Budget 2023 proposes a new refundable investment tax credit for clean technology manufacturing and processing, and critical mineral extraction and processing (Clean Technology Manufacturing ITC). The credit will be equal to 30% of the capital cost of depreciable property that is used all or substantially all for eligible activities. Based on the Budget 2023 documents, the Labour Requirements do not apply to the Clean Technology Manufacturing ITC.

Eligible property includes machinery and equipment, including certain industrial vehicles, used in manufacturing, processing or critical mineral extraction, as well as related control systems.

Eligible activities include: the manufacturing of certain renewable energy equipment (solar, wind, water, or geothermal); manufacturing of nuclear energy equipment; processing or recycling of nuclear fuels and heavy water; manufacturing of nuclear fuel rods; manufacturing of grid-scale electrical storage equipment; manufacturing of zero-emissions vehicles and manufacturing; manufacturing of batteries, fuel cells, recharging systems, and hydrogen refueling stations for zero-emission vehicles; manufacturing of equipment used to produce hydrogen from electrolysis; and manufacturing or processing of upstream components for such activities.

Eligible activities would also include 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.

The Clean Technology Manufacturing ITC would apply to property that is acquired and becomes available for use on or after January 1, 2024. The credit would be gradually phased out and will apply at a rate of 30% for property that becomes available for use from 2024 to 2031, 20% for property that becomes available for

use in 2032, 10% for property that becomes available for use in 2033 and 5% for property that becomes available for use in 2034. It would cease to be available for property that becomes available for use after 2034.

The Clean Technology Manufacturing ITC would not be available for property used in the production of battery cells or modules if such production benefits from direct support through a Special Contribution Agreement with the Government.

Clean Electricity Investment Tax Credit

To support and accelerate clean electricity investment in Canada, Budget 2023 proposes to introduce the Clean Electricity ITC, which will be a 15% refundable tax credit for the following eligible investments:

- Non-emitting electricity generation systems: wind; concentrated solar; solar photovoltaic; hydro (including large-scale); wave; tidal; 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 are intended to be eligible for the Clean Electricity ITC. The rate will be reduced by 10% where the Labour Requirements are not met.

Taxable and non-taxable entities such as Crown corporations and publicly owned utilities, corporations owned by Indigenous communities, and pension funds, would be eligible for the Clean Electricity ITC.

The Clean Electricity ITC would be available as of the day of Budget 2024 for projects that did not begin construction before Budget Day. The Clean Electricity ITC would not be available after 2034 – unlike the other credits, there is no phase-out period.

The Government intends to engage with provinces and territories to develop the design and implementation details of the Clean Electricity ITC, and Labour Requirements will be required to obtain the full credit. No specific legislation has been proposed at this time.

Investment Tax Credit for Carbon Capture, Utilization and Storage

Budget 2021 announced the Government’s intention to introduce an investment tax credit for capital invested in CCUS projects. Budget 2022 provided additional details and draft legislation was introduced on August 9, 2022 (August 2022 Proposals). The Government engaged in public consultations following the

release of the August 2022 Proposals, and such consultations form the basis for the additional design details that are proposed in Budget 2023.

The August 2022 Proposals introduced new section 127.44 of the Tax Act and accompanying regulations which provide for the refundable CCUS Tax Credit. The August 2022 Proposals introduced four new CCA classes (Classes 57, 58, 59, and 60). The CCUS Tax Credit (as amended by Budget 2023) will generally apply to qualifying expenditures incurred on or after January 1, 2022 and before 2041.

The CCUS Tax Credit will apply to eligible expenses incurred after 2021 through 2030 for equipment at the following rates:

- 60% for eligible capture equipment used in direct air capture projects;
- 50% for eligible capture equipment used in projects other than direct air capture projects; and
- 5% for eligible transportation, storage, and use equipment.

The CCUS Tax Credit will be reduced by 50% for eligible expenses that are incurred after 2030 through 2040.

The Labour Requirements are also intended to apply to the CCUS Tax Credit. However, no specific draft legislation has been proposed at this time.

Eligible Jurisdictions for Dedicated Geological Storage

Budget 2023 proposes to add British Columbia as an eligible jurisdiction for dedicated geological storage, applicable to expenses incurred on or after January 1, 2022. Alberta and Saskatchewan are currently on the list of eligible jurisdictions for dedicated geological storage.

Eligible Equipment – Dual Use Equipment

Budget 2023 proposes that dual use equipment that produces heat and/or power or uses water that is used for CCUS as well as other processes, be eligible for the CCUS Tax Credit. The cost of this equipment could qualify for the CCUS Tax Credit on a pro-rated basis if the energy balance is expected to be primarily (i.e., more than 50%) used to support the CCUS process or a hydrogen production project that is eligible for the Clean Hydrogen ITC.

In order for power and/or heat production equipment to be eligible for the CCUS Tax Credit, CO_2 emissions from such equipment must be captured and stored or used.

Eligible Use – Concrete Storage

Budget 2022 provided that storage in concrete would be considered an eligible use for purposes of the CCUS Tax Credit if approved by Environment and Climate Change Canada and the taxpayer demonstrate that at least 60% of the CO_2 that is injected in the concrete is mineralized and locked into the concrete produced.

Budget 2023 proposes to revise the validation procedure by permitting validation by a qualified third party based on an ISO standard (rather than Environment and Climate Change Canada), which would confirm that the process meets the minimum mineralization standard. Validation must be confirmed before any CCUS Tax Credit relating to CO_2 storage in concrete can be claimed.

Refurbishment Costs

Budget 2023 responds to comments received during the public consultation process with respect to refurbishment costs and proposes that the CCUS Tax Credit will be available for eligible refurbishment costs incurred once the project is operating (Refurbishment ITCs). Budget 2023 provides the basis for the calculation of the Refurbishment ITC and limits the eligible refurbishment costs over the first 20 years of the project to a maximum of 10% of the total pre-operational costs that were eligible for the CCUS Tax Credit. The Refurbishment ITC would not be available for costs incurred after the end of the 20-year period.

The Refurbishment ITC will generally be calculated in the same manner as the CCUS Tax Credit (i.e., during the construction phase) with adjustments for the fact that the recovery period will be shorter than the 20-year period. An illustrative example of the Refurbishment ITC calculation is provided in the supplementary information accompanying Budget 2023.

Knowledge Sharing and Climate Risk Disclosure

Budget 2023 includes proposed Part XII.7 of the Tax Act, which will impose a knowledge sharing requirement for CCUS projects with eligible expenses of $250 million or greater over the life of the project. Proposed section 211.92 will require both a construction and completion knowledge sharing report and an annual operations knowledge sharing report. Taxpayers that fail to provide the required reports in respect of any reporting period by the applicable reporting due date will be liable to a penalty of $2 million payable immediately.

Draft legislation for the remainder of the Budget 2023 proposals relating to the CCUS Tax Credit will be released in the coming months.

Interaction of Investment Tax Credits

Taxpayers will only be able to claim one of the Clean Hydrogen ITC, the Clean Technology ITC, the Clean Technology Manufacturing ITC, the CCUS Tax Credit, and the Clean Electricity ITC for a particular property.

However, multiple credits may be available for the same project if the project includes different types of eligible properties.

The Clean Hydrogen ITC, Clean Technology Manufacturing ITC, and the Clean Electricity ITC can be combined with the Atlantic Investment Tax Credit.

Zero-Emission Technology Manufacturers

Subsection 125.2(2) of the Tax Act contains the temporary measure (introduced in Budget 2021) to reduce corporate income tax rates on eligible zero-emission technology manufacturing and processing income by 50%.

Budget 2023 proposes to expand the scope of activities to include manufacturing of nuclear energy equipment, processing or recycling of nuclear fuels and heavy water, and manufacturing of nuclear fuel rods. The expansion of eligible activities would apply for taxation years beginning after 2023.

Currently, the reduced tax rates are scheduled to be gradually phased out starting in taxation years beginning in 2029 and fully phased out for taxation years beginning after 2031. Budget 2023 proposes to extend the availability of the reduced tax rates by three years such that the phase-out would start in taxation years beginning in 2032 and be fully phased out for taxation years beginning in 2034.

Critical Mineral Exploration Tax Credit – Lithium from Brines

Budget 2023 proposes to amend the Tax Act to expand the definition of “mineral resource” to include lithium from brines.

This will allow relevant principal business corporations that undertake specified exploration and development activities related to lithium from brines to issue flow-through shares to investors and renounce specified expenses that may be eligible for the 30% non-refundable Critical Mineral Exploration Tax Credit.

This measure would apply to flow-through share agreements entered into after Budget Day and before April 2027.

2% Tax on Repurchases of Equity

Budget 2023 provides details on the 2% tax on the net value of equity repurchases by certain publicly traded entities that was initially announced in the 2022 Fall Economic Statement. The tax will generally apply to public corporations resident in Canada as well as certain publicly traded mutual fund trusts, including “real

estate investment trusts" and "SIFT trusts," and publicly traded partnerships that are "SIFT partnerships." The tax will also apply to trusts and partnerships that would be SIFT trusts or SIFT partnerships if their assets were located in Canada. Normal course issuer bids and substantial issuer bids will constitute a repurchase of equity for purposes of the 2% tax.

The 2% tax is an annual tax that will apply to the net amount of shares or units repurchased or issued after January 1, 2024, computed as the difference between the fair market value of any shares or units repurchased less the fair market value of shares or units issued from treasury, but only to the extent the gross amount of equity repurchased is $1 million or more in a taxation year (pro-rated for short taxation years). A corporation, trust or partnership that is subject to the tax (a Covered Entity) will be required to timely file a prescribed form and remit the tax.

The 2% tax is subject to certain exceptions and anti-avoidance rules. The exceptions will apply to the issuance and cancellation of debt-like preferred shares and units and the issuance and cancellation of equity of a Covered Entity as part of a specified reorganization or acquisition transactions, including an exchange of shares by a shareholder of a Covered Entity and an amalgamation of a Covered Entity with one or more predecessor corporations, where the shareholder of a Covered Entity receives no consideration other than shares of either the Covered Entity or the amalgamated corporation, respectively.

The redemption, acquisition, cancellation, or issuance of "debt-like" preferred shares (substantive debt) are excluded from the determination of the net equity repurchased. Substantive debt includes non-voting preferred shares with a dividend that is a fixed percentage of the fair market value for which the shares were issued, provided that the shares are not convertible or exchangeable into shares other than shares that would be substantive debt. Additionally, the amount that the holder can receive on the redemption, acquisition or cancellation of the equity by the issuer or a person or partnership that does not deal at arm's length with the issuer or is affiliated with the issuer, cannot exceed the fair market value of the subscription proceeds plus accrued, but unpaid, dividends or distributions.

Anti-avoidance rules may apply where the equity of a Covered Entity:

- is acquired by a corporation, trust or partnership (affiliate) that the Covered Entity controls or owns more than 50% of the fair market value of the equity of the affiliate, regardless of whether the control or ownership is direct or indirect, unless the equity is acquired by certain registered securities dealers for resale to customers or held in a trust that is an employee benefit plan that provides that the equity of the Covered Entity cannot be transferred to the Covered Entity or an affiliate;
- is redeemed, acquired, cancelled, or issued if it is reasonable to consider that the primary purpose of the transaction was effectively to reduce the net amount that is subject to the tax; or
- is acquired by a person or partnership where it is reasonable to consider that one of the main purposes of the acquisition was to avoid the tax.

Certain details about the tax remain unclear. For example, the rules do not provide an exception for a share redemption that occurs in the context of a publicly traded SPAC undertaking a qualifying transaction and continuing into Canada. If unissued stock is issued as part of the series that includes the share redemption, the fair market value of the unissued stock may reduce the tax payable, since the primary purpose may be to raise equity and not to reduce the tax payable.

General Anti-Avoidance Rule

In August 2022, the Department of Finance (Department) published a consultation paper with respect to the GAAR to consult with Canadians on approaches to "strengthening and modernizing the GAAR" (Consultation Paper).

Budget 2023 includes draft legislation to implement some of the changes proposed in the Consultation Paper. The Government has also opened a consultation period requesting comments on the draft legislation that will run until May 31, 2023. After such time, the Government intends to publish revised legislative proposals and announce the application date of the amendments.

Preamble

A preamble is proposed to be added to the GAAR to "help address interpretive issues and ensure that the GAAR applies as intended." Budget 2023 states that the addition of a preamble would address three areas of the GAAR where questions have arisen: (1) the balance between taxpayers being free to arrange their affairs so as to obtain tax benefits intended by Parliament with the need to prevent taxpayers from misusing or abusing the tax rules to obtain unintended tax benefits; (2) the role of the GAAR in striking a balance between taxpayers' need for certainty in planning their affairs and the Government's responsibility to protect the tax base and the fairness of the tax system; and (3) clarifying that the GAAR is intended to apply regardless of whether or not the tax planning strategy used to obtain the tax benefit was foreseen.

Part of the GAAR analysis developed through case law requires an examination of the object, spirit, and purpose of a provision of the Tax Act and whether a particular transaction falls within or frustrates that object, spirit, and purpose. The addition of preambles to certain provisions of the Tax Act was one of the proposed solutions in the Consultation Paper to address the difficulty in ascertaining the object, spirit, and purpose of provisions of the Tax Act and the existence and relevance of a general scheme in the Tax Act read as a whole in determining whether abusive tax avoidance has occurred. Interestingly, the Consultation Paper focused on adding preambles to discrete sections of the Tax Act, rather than adding a preamble to the GAAR. While it remains to be seen how a court will interpret a preamble that includes statements like "strikes a balance," "need for certainty," "responsibility to protect the tax base," and "fairness of the tax system," this may be a welcome proposal in contrast to one of the proposed solutions in the Consultation Paper that was not included in Budget 2023's proposed GAAR amendments, which was to reverse the

judicially established onus and require the taxpayer (rather than the Minister) to demonstrate that a tax benefit is consistent with the object, spirit, and purpose of the particular provision.

Avoidance Transaction

Budget 2023 proposes to reduce the threshold for the avoidance transaction test in the GAAR from a "primary purpose" test to a "one of the main purposes" test. There were a number of concerns expressed in the Consultation Paper with respect to the avoidance transaction threshold, including whether the avoidance of foreign tax should be considered a *bona fide* purpose. The Government anticipates that the amendment to the definition of "avoidance transaction" will produce appropriate results and no further amendments to address these issues are proposed.

Economic Substance

In response to the Supreme Court of Canada placing limited emphasis on the economic substance of a transaction as part of the GAAR analysis, the Government proposes to amend the Tax Act to require economic substance to be considered at the "misuse or abuse" stage of the GAAR analysis. A lack of economic substance would "tend to indicate" abusive tax avoidance.

The Budget 2023 draft legislation provides a non-exhaustive list of indicators to help determine whether a transaction or series of transactions lacks economic substance. The existence of one or more of the following indicators would strongly point to a transaction lacking economic substance:

- whether there is 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.

In response to concerns from the tax practitioner community, Budget 2023 confirms that not all instances where a transaction lacks economic substance will constitute abusive tax avoidance. In cases where the tax results are consistent with the purpose of the provisions relied upon, abusive tax avoidance would not be found even in cases lacking economic substance. It will be interesting to see how the ambiguous phrase "tends to indicate," which is novel to the Tax Act, will be interpreted by the Courts.

Penalty

Under the current GAAR provisions, there is no specific penalty that applies to taxpayers if the Canada Revenue Agency (CRA) is ultimately successful in imposing the GAAR. Instead, the taxpayer would be denied the tax benefit in question and subject to interest on the tax owing. Budget 2023 proposes a 25% penalty of the amount of a tax benefit in transactions subject to the GAAR. If a tax benefit involves a tax attribute that has not yet been used to reduce tax, the amount of the tax benefit would be considered nil.

The penalty may be avoided if the transaction was disclosed to the CRA as part of the reportable transaction rules or voluntarily. The proposed reportable transaction rules will be amended to permit voluntary disclosure for GAAR purposes.

Reassessment Period

In order to provide the CRA with more time to detect and assess transactions to which the GAAR should apply, reduce the odds of non-detection, and increase the deterrent effect of the GAAR, Budget 2023 proposes to extend the normal reassessment period for GAAR assessments by three years, unless the transaction has been disclosed to the CRA.

Since the extended reassessment period should not apply to transactions which have been disclosed to the CRA under the mandatory disclosure rules, it will be important for taxpayers to fulfill their reporting obligations under those rules. The associated draft legislation provides that the exception applies if "the transaction was disclosed by the taxpayer to the Minister." This would seem to mean that the taxpayer's disclosure is sufficient, even if an advisor or other parties to the transaction have not fulfilled their reporting obligations. Voluntary disclosures would also seem to exempt a taxpayer from the extended reassessment period.

Dividend Received Deduction by Financial Institutions

Dividends received by financial institutions on Canadian shares that are mark-to-market properties, which are generally shares of companies held by financial institutions in the ordinary course of their business in which the financial institution has less than 10% of the votes or value, are not treated as business income and are exempt from tax. Budget 2023 introduces new rules to deny the dividend received deduction in respect of dividends received by financial institutions on shares that are mark-to-market property. This measure is intended to apply to dividends received after 2023 and is expected to increase federal revenues by $3.15 billion over five years commencing in 2024-2025.

Scientific Research and Experimental Development (SR&ED)

In Budget 2022, the 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. Budget 2023 did not announce any changes, but the Department indicated it will continue to engage with stakeholders on the next steps in the coming months.

INTERNATIONAL TAX MEASURES

Pillar One Update – Reallocation of Taxing Rights

Budget 2023 confirms that the Government is working with its international partners in an OECD-led process to develop the model rules and the multilateral convention needed to establish the Pillar One framework.

The Government released the draft *Digital Services Tax Act* for public comment on December 14, 2021. The digital services tax (DST) is only intended to apply if a multilateral convention implementing the Pillar One framework has not come into force by January 1, 2024. In Budget 2023, the Government confirmed its intention to release a revised draft of the legislative proposals. It will be interesting to see how the Government intends to address comments made by the Office of the United States Trade Representative in February 2022 regarding the DST in which the United States expressed serious concerns about Canada "pursuing a counterproductive unilateral measure" and instead, urged Canada to "focus efforts on engaging constructively in the multilateral OECD negotiations."

Pillar Two Update – Global Minimum Tax

Consistent with the announcement in Budget 2022, Budget 2023 announces the Government's intention to introduce legislation implementing the Income Inclusion Rule (IIR), the primary charging rule for Pillar Two, and a domestic minimum top-up tax applicable to Canadian entities of multinational enterprises (MNEs) that are within scope of Pillar Two, with effect for fiscal years of MNEs that begin on or after December 31, 2023.

The Government also intends to implement the Undertaxed Profits Rule (UTPR), a backstop rule contained in Pillar Two, with effect for fiscal years of MNEs that begin on or after December 31, 2024.

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

OTHER TAX MEASURES

Employee Ownership Trusts

Budget 2023 includes the much-anticipated proposals relating to EOTs. EOTs facilitate employee ownership

of Canadian businesses through a dedicated trust structure and provides business owners an additional option for succession planning. EOT structures exist in the United States and the United Kingdom. The Government first announced its intention to examine EOTs and how employees of Canadian businesses could benefit from the use of EOTs as well as the barriers to the creation of EOTs in Budget 2021.

Draft legislation has been proposed as part of Budget 2023 and the rules are intended to apply as of January 1, 2024. These measures are expected to cost the Government approximately $20 million in revenues over the next four years.

The draft legislation includes new rules which set out qualifying conditions that would apply to EOTs and proposes changes to certain tax rules to facilitate the establishment of EOTs.

A trust would generally be considered an EOT if it is a Canadian resident trust (excluding deemed resident trusts) and only has two purposes:

1. to hold shares of qualifying businesses for the benefit of qualifying employee beneficiaries of the EOT; and
2. where reasonable, to make distributions to employee beneficiaries under a distribution formula that could only consider an employee's length of service, remuneration, and hours worked.

Other than the components of the formula above, all employee beneficiaries must generally be treated in the same manner.

The EOT would be required to hold a controlling interest (more than 50%) in the shares of one or more qualifying businesses. All or substantially all (generally, 90%) of an EOT's assets must be shares of qualifying businesses. A qualifying business is generally a Canadian-controlled private corporation where 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.

With respect to governance, the trustees of an EOT must be Canadian residents (excluding deemed residents). The EOT beneficiaries who are 18 and older would select the trustees at least once every five years. If an existing business is transferred to an EOT, individuals (including 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, the directors of a corporation serving as a trustee of the EOT, or directors of any qualifying business of the EOT.

The beneficiaries of the EOT must consist exclusively of qualifying employees, who are individuals employed by a qualifying business and any other qualifying business controlled by it. Employees who hold a significant economic interest in a qualifying business of the EOT or who have not completed a reasonable probationary period would not be qualifying employees.

The EOT would be a taxable trust; undistributed trust income would be taxed in the EOT at the top personal marginal tax rate and trust income distributed to beneficiaries would only be subject to tax at the beneficiary level. Dividends distributed by an EOT to beneficiaries would retain their dividend character and thus be eligible for the dividend tax credit.

Budget 2023 also proposes the following changes to existing rules to facilitate the acquisition of shares by an EOT:

- The 5-year capital gains reserve is proposed to be extended to 10 years for qualifying business transfers to an EOT. A qualifying business transfer would occur where a taxpayer disposes of shares of a qualifying business to an EOT (or a corporation wholly owned by an EOT) for no more than fair market value with the result that the EOT owns a controlling interest in the qualifying business immediately after the disposition.
- A new exception to the shareholder loan rules is proposed, which would extend the repayment period to 15 years for amounts loaned to an EOT to purchase shares in a qualifying business transfer.
- EOTs are proposed to be exempted from the 21-year deemed disposition rule (which normally prevents an indefinite deferral of tax on accrued capital gains of trusts) since EOTs are intended to allow for shares to be held indefinitely for the benefit of employees.

Budget 2023 also provides that additional restrictions may be included to the EOT rules, as necessary, to protect the integrity of the tax system.

Alternative Minimum Tax for High-Income Individuals

Consistent with the Government's announced intentions in the 2022 Federal Budget and the 2022 Fall Economic Statement, Budget 2023 proposes certain amendments to the existing AMT "to better target the AMT to high-income individuals."

The AMT rules provide a different method of calculating income by allowing fewer deductions, exemptions, and tax credits than under the ordinary income tax rules and applies a 15% tax rate with a $40,000 exemption amount. A taxpayer is liable to pay either the AMT or their taxes calculated under the ordinary rules (regular tax), whichever is higher. Additional tax paid as a result of the AMT can generally be carried forward for seven years and credited against regular tax to the extent regular tax exceeds AMT in any of those years.

Broadening the AMT Base

Budget 2023 proposes the following changes to broaden the income included under the AMT rules (AMT

Base):

- Increase the AMT capital gains inclusion rate from 80% to 100%. Capital loss carryforwards and allowable business investment losses would apply at a 50% rate.
- 100% of the benefit associated with employee stock options would be included in the AMT Base.
- 30% of the capital gains on donations of publicly listed securities is proposed to be included in the AMT Base. This would also apply to the 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.

Budget 2023 also confirmed that the Government intends to maintain the inclusion of 30% of capital gains eligible for the lifetime capital gains exemption in the AMT Base.

In addition, Budget 2023 broadens the AMT Base by disallowing 50% of certain deductions and expenses, including the following: employment expenses, other than those to earn commission income; deductions for CPP and QPP; moving expenses; childcare 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 tax credits would be credited at a rate of 50%, rather than 100% (which is the case in the current rules). The Special Foreign Tax Credit would continue to be allowed in full.

Raising the AMT Exemption

The exemption amount (currently $40,000) is intended to protect lower and middle-income individuals from the AMT. To ensure the AMT continues to target the “very wealthy,” the Government proposes to increase the exemption to $173,000 (i.e., the start of the fourth federal tax bracket). This amount would be indexed annually to inflation.

Increasing the AMT Rate

Budget 2023 proposed to increase the current AMT rate of 15% to 20.5%.

No specific draft legislation has been proposed at this time. The proposed AMT rules are intended to come into force for taxation years beginning after 2023 and will generate approximately $2.9 billion of revenue for the Government over five years.

Strengthening the Intergenerational Business Transfer Framework

Prior to the introduction of Bill C-208, the transfer of shares of a corporation by an individual to a corporation owned by their children or grandchildren resulted in a deemed dividend whereas a transfer of the shares by the individual to an arm's length third-party would result in a capital gain potentially eligible for the lifetime capital gains exemption. Thus, individuals were incentivized to transfer shares outside the family unit rather than to family members that may have desired to carry on the family business. Bill C-208, a private member's bill, was introduced (and ultimately enacted) in order to address this inequity by providing capital gains treatment for transfers to children and grandchildren. The Department was concerned that Bill C-208 contained insufficient safeguards to guard against situations where there is no genuine transfer of a business to the next generation.

Budget 2023 proposes to amend the rules introduced by Bill C-208 to ensure that they apply only where there is a genuine intergenerational business transfer involving shares of a "qualified small business corporation" or shares of a "family farm or fishing corporation." These measures would apply to transactions that occur on or after January 1, 2024, and specific draft legislation has been proposed. These measures are expected to increase Government revenues by approximately $1 billion over five years.

The proposed rules provide two different transfer options for taxpayers who wish to undertake a genuine intergenerational share transfer to their children: (1) an immediate intergenerational business transfer; or (2) a gradual intergenerational business transfer. For the purposes of these rules, "child" includes grandchildren, stepchildren, children-in-law, nieces and nephews, and grandnieces and grandnephews. The following table compares the proposed conditions attached to each transfer option.

Proposed Conditions	**Immediate Business Transfer (Three-Year Test)**	**Gradual Business Transfer (Five-to-Ten-Year Test)**
Transfer of Control of the Business	Parents immediately and permanently transfer both legal and factual control, including an immediate transfer of a majority of voting shares, and a transfer of the balance of voting shares within 36 months	Parents immediately and permanently transfer only legal control (i.e., right to elect a majority of the directors), including an immediate transfer of a majority of voting shares, and a transfer of the balance of voting shares within 36 months
Transfer of Economic Interests in the Business	Parents immediately transfer a majority of the common shares, and transfer the balance of common shares within 36 months	Parents immediately transfer a majority of the common shares, and transfer the balance of common shares within 36 months. In addition, within 10 years of the initial sale, parents reduce the economic value of their debt and equity interests in

		the business to (a) 50% of the value of their interest in a farm or fishing corporation at the initial sale time; or (b) 30% of the value of their interest in a small business corporation at the initial sale time
Transfer of Management of the Business	Parents transfer management of the business to their child within a reasonable time based on the particular circumstances (with a 36-month safe harbour)	Parents transfer management of the business to their child within a reasonable time based on the particular circumstances (with a 36-month safe harbour)
Child Retains Control of the Business	Child(ren) retain(s) legal (not factual) control for a 36-month period following the share transfer	Child(ren) retain(s) legal (not factual) control for the greater of 60 months or until the business transfer is completed
Child Works in the Business	At least one child remains actively involved in the business for the 36-month period following the share transfer	At least one child remains actively involved in the business for the greater of 60 months or until the business transfer is completed

The rules in Bill C-208 that apply to subsequent share transfers and the lifetime capital gains exemption are proposed to be replaced by relieving rules that would apply on a subsequent arm's length share transfer or upon the death or disability of the child.

A joint election would be required to be filed by the transferor and the child (or children) in order for a transfer to qualify as either an immediate or gradual intergenerational share transfer. The child (or children) would be joint and severally liable for any additional taxes payable as a consequence of the application of section 84.1 of the Tax Act which would recharacterize a capital gain into a dividend if the transfer does not satisfy the requisite conditions.

Budget 2023 also proposes to extend the limitation period for reassessing a transferor's liability for tax on an immediate business transfer by 3 years and on a gradual business transfer by 10 years. The capital gains reserve is proposed to be extended to 10 years for genuine intergenerational transfers that satisfy the requisite conditions.

ADDITIONAL ECONOMIC INVESTMENTS

Supporting Indigenous Economic Participation in Major Projects

Budget 2023 proposes to provide $8.7 million in 2023 and 2024 to Natural Resources Canada to support deeper engagements with Indigenous partners, including Indigenous rights-holders, towards the development of the National Benefits-Sharing Framework.

Budget 2023 also announces that the Canada Infrastructure Bank will provide loans to Indigenous communities to support them in purchasing equity stakes in infrastructure projects in which the Canada Infrastructure Bank is also investing. These loans will be sourced from the Canada Infrastructure Bank's existing funding envelope.

Supporting Clean Electricity Projects

To build Canada's electricity industry, Budget 2023 proposes to provide $3 billion to Natural Resources Canada, over 13 years, starting in 2023 to 2024 to, among other things, recapitalize funding for the Smart Renewables and Electrification Pathways Program to support critical regional priorities and Indigenous-led projects, and add transmission projects to the program's eligibility.

Consumer Protection and Financial Crime Measures

Budget 2023 also introduced certain consumer protection and financial crime measures that will impact businesses operating in Canada. For more details, please see our Comment on these measures.

PREVIOUSLY ANNOUNCED TAX MEASURES

Budget 2023 also 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. We have highlighted certain previously announced measures which may be of particular importance.

- Legislative proposals released on November 3, 2022, with respect to Excessive Interest and Financing Expenses Limitations (EIFEL) and Reporting Rules for Digital Platform Operators.
- 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:
    - Borrowing by Defined Benefit Pension Plans;
    - Reporting Requirements for Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs);
    - Fixing Contribution Errors in Defined Contribution Pension Plans;
    - The Investment Tax Credit for Carbon Capture, Utilization and Storage;
    - Hedging and Short Selling by Canadian Financial Institutions;
    - Substantive Canadian-Controlled Private Corporations;
    - Mandatory Disclosure Rules;
    - The Electronic Filing and Certification of Tax and Information Returns;
    - Canadian Forces Members and Veterans Amounts;
    - 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 April 29, 2022, with respect to Hybrid Mismatch Arrangements.
- Legislative proposals released on February 4, 2022, with respect to the Goods and Services Tax/Harmonized Sales Tax treatment of Cryptoasset 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.
- The income tax measure announced on December 20, 2019, to extend the maturation period of amateur athletes trusts maturing in 2019 by one year, from eight years to nine years.
- Measures confirmed in Budget 2016 relating to the Goods and Services Tax/Harmonized Sales Tax joint venture election.

EIFEL

After receiving submissions on draft legislation released on February 4, 2022, the Department released revised draft legislation on November 3, 2022, with respect to the EIFEL rules. Although not discussed in Budget 2023, numerous outstanding issues with respect to the revised EIFEL rules were highlighted in a document published by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (Joint Committee). Of particular note are the issues raised by the Joint Committee that relate to the interaction of the EIFEL rules and the foreign affiliate regime. Generally, the EIFEL rules will limit the amount of interest and other financing expenses that corporations and trusts may deduct for Canadian income tax purposes. The EIFEL rules are intended to apply to taxation years beginning on or after October 1, 2023.

Reporting Requirements for RRSPS and RRIFS

Budget 2022 proposed an annual reporting requirement for financial institutions to report the total fair market value, determined at the end of the calendar year, of property held in each RRSP and RRIF administered by a particular financial institution. On August 9, 2022, the Government released draft legislation with respect to this requirement. Budget 2023 did not provide any additional information but the requirement to report is intended to apply to the 2023 taxation year and subsequent taxation years.

Mandatory Disclosure Rules

Budget 2023 did not provide further details with respect to the mandatory disclosure rules announced in the 2021 Federal Budget. The Department published a news release on November 3, 2022, providing that the revised rules with respect to reportable transactions and the new rules with respect to notifiable transactions will apply as of the date the enacting legislation receives Royal Assent. The rules were initially proposed to apply to all transactions entered into on or after January 1, 2022. However, the rules with respect to uncertain tax treatments will still apply to taxation years beginning after 2022.

Hybrid Mismatch Arrangements

The first package of legislation with respect to hybrid mismatch arrangements was released on April 29, 2022, and the rules are intended to apply to payments arising on or after July 1, 2022. Generally, the hybrid mismatch rules are intended to address hybrid mismatch arrangements where a deduction is allowed in one country in respect of a cross-border payment and its receipt is not fully included in income in the other country. A second package of legislation is expected.

If you have any questions about Budget 2023, please contact any member of the Cassels Tax Group.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.