2023 federal budget analysis

This year's federal budget, titled *A Made-in-Canada Plan: Strong Middle Class, Affordable Economy, Healthy Future*, didn't introduce measures that directly impact life insurance or living benefits. Some measures have a minor impact on wealth products. Various proposed tax measures impact both individuals and businesses.

The headline items in the budget include a national dental care plan for lower income people, numerous funding and tax credit initiatives for promoting a green economy and a "grocery rebate," which is a one-time payment of cash to approximately 11 million lower-income people who receive the GST tax credit. The budget projects a $40.1 billion deficit for the fiscal year that begins April 1, which is forecasted to drop to $14 billion by 2027-28.

The following tax measures introduced in the budget may be of interest to advisors.

Intergenerational business transfers

Budget 2023 proposes to amend the intergenerational family business transfer rules that were enacted by Bill C-208. These rules came into effect in 2021 and are intended to provide tax relief for transfers of shares of "qualified small business corporation share[s]" or a "share of the capital stock of a family farm or fishing corporation" (both as defined in the *Income Tax Act* (ITA) to a corporation controlled by an adult child of the transferor. The meaning of "child" for these purposes includes grandchildren, step-children, children-in-law, nieces and nephews, and grandnieces and grandnephews.

The tax relief from Bill C-208 is intended to allow the transferor parent/grandparent to achieve capital gains treatment on the sale of their shares to the adult child's corporation (and thus access to the lifetime capital gain exemption [CGE]) instead of receiving deemed dividend tax treatment under an anti-avoidance rule. The government, however, became concerned that this tax relief was too broad and that it was allowing business owners to facilitate "surplus stripping" transactions, which in effect allow them to receive distributions from their corporations at capital gains tax rates instead of at higher dividend tax rates.

Budget 2023 proposes rules designed to ensure that only genuine intergenerational share transfers take place. The rules appear to be tedious and may operate for several years after share sale to the adult child's corporation. The rules provide that a transferor (for example, a parent or grandparent) and their adult child may jointly elect to choose to rely on one of two transfer options for obtaining the tax relief provided by Bill C-208:

1. A three-year "immediate" intergenerational business transfer, or
2. A five- to 10-year "gradual" intergenerational business transfer

Based on the option chosen, various tests must be satisfied relating to the transfer of the voting control of the corporation, economic interests in the business, management of the business, and the adult child's involvement in the business and their corporation's retention of the shares. The adult child would be jointly and severally liable for any additional taxes payable by the transferor in case these conditions aren't met.

Fortunately, Budget 2023 also proposes to provide a 10-year capital gains reserve for genuine intergenerational share transfers that satisfy the above noted conditions. The regular capital gains reserve is five years.

These measures would apply to transactions that occur on or after Jan. 1, 2024.

Alternative minimum tax

Budget 2023 proposes to update the alternative minimum tax (AMT) regime, which has largely been untouched since its introduction in 1986. The updates serve to broaden the application of AMT, increase the AMT tax rate and target the tax to high-income individuals.

AMT is a parallel tax calculation that allows fewer tax deductions and credits than under the ordinary income tax rules. AMT currently applies a flat 15% tax rate with a small $40,000 exemption. The taxpayer pays the AMT or regular tax, whichever is higher. AMT paid can be carried forward for seven years and credited against regular tax, assuming regular tax exceeds AMT in those years. The AMT doesn't apply in the year of death and only graduated rate estates have access to the $40,000 exemption (not other testamentary trusts). Provinces have a parallel provincial AMT.

To target high-income individuals, the government proposes to increase the AMT exemption from $40,000 to approximately $173,000 for the 2024 taxation year. The exemption amount would be indexed annually to inflation.

The proposed changes to AMT will also broaden its application by:

- Increasing the AMT capital gains inclusion rate from 80% to 100%
- Including 100% of the benefit associated with employee stock options
- Including 30% of capital gains on donations of publicly listed securities, including employee stock options to the extent that a deduction is available because the underlying securities are publicly listed securities
- Disallowing various deductions from AMT
- Restricting certain non-refundable tax credits from being credited against AMT

Finally, Budget 2023 proposes to increase the AMT tax rate from 15% to 20.5%.

Under the current rules, most business owners typically don't encounter AMT unless they sell shares of their business and claim the CGE. In this context where the CGE is claimed, 30% of the capital gains eligible for the exemption are included in calculating the AMT base. Fortunately, Budget 2023 indicates that this treatment of only including 30% of the capital gain in the AMT base will be preserved.

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

Employee ownership trusts

Budget 2023 proposes new rules to enable the use of an employee ownership trust (EOT) to purchase and hold shares of a business. An EOT is a trust that will hold shares of a corporation pursuant to a qualifying business transfer for the benefit of the corporation's employees. Where employees are interested in acquiring a business, an EOT provides them with an option to do so without having to buy the shares directly.

The new rules will outline qualifying conditions and changes to existing tax rules to enable the creation and use of an EOT to purchase shares.

A qualifying business transfer will occur when shares of a qualifying business are sold by a taxpayer to the EOT for no more than fair market value; shares are sold to either a trust that qualifies as an EOT immediately after the sale or to a corporation wholly owned by the EOT; and the EOT owns a controlling interest in the qualifying business immediately after the sale.

A qualifying business must meet certain conditions, including all or substantially all of the fair market value of its assets are used in an active business carried on in Canada and it cannot carry on its business as a partnership.

An EOT will generally be taxed similar to other personal trusts. Trust income not distributed to beneficiaries will be taxed in the EOT at the top personal marginal tax rate. Trust income that's distributed to a beneficiary will be taxed in the hands of the beneficiary. Any dividends received by the EOT from a qualifying business and distributed to its employee beneficiaries will retain their character as dividends and be eligible for the dividend tax credit.

In addition, other existing tax rules will be amended to accommodate the use of EOTs. The capital gains reserve period will be extended from five years to 10 years for qualifying business transfers to an EOT. A new exception to the current shareholder loan rules will be added to extend the repayment period to 15 years (currently one year) for amounts loaned to the EOT from a qualifying business to purchase shares in a qualifying business transfer. EOTs will be exempt from the 21-year deemed disposition rule that applies to certain trusts.

The EOT rules will apply starting Jan. 1, 2024.

Retirement compensation arrangements

A retirement compensation arrangement (RCA) is an employer-sponsored plan that allows an employer to provide supplemental pension benefits to employees. An RCA is subject to a refundable tax, imposed at a rate of 50%, on contributions to an RCA trust, as well as on income and gains earned or realized by the trust. This tax is generally refunded as the retirement benefits are paid from the RCA trust to the employee.

If benefits are not pre-funded (meaning obligations are paid from earnings as benefits come due), the employer can obtain a letter of credit (or a surety bond), for which a fee is charged by the financial institution. This fee is subject to the refundable tax regime. If the fee was paid to the institution providing the service, an equal amount must also be paid on account of refundable taxes.

When retirement benefits become due from an unfunded plan, the employer pays the benefits out of corporate revenues. Consequently, there are no benefit payments from an RCA trust to trigger a 50% refund, and employers are required to fund escalating refundable tax balances with no practical mechanism for recovery.

Budget 2023 proposes to amend the ITA so that fees or premiums paid for the purposes of securing or renewing a letter of credit for an RCA that is supplemental to a registered pension plan will not be subject to the refundable tax.

This change would apply to fees or premiums paid on or after March 28, 2023, and includes a refund mechanism for previously paid fees or premiums.

Registered educational savings plans

A registered education savings plan (RESP) is an investment designed to help families save for their child's post-secondary education.

Increasing educational assistance payment withdrawal limits

An educational assistance payment (EAP) is the amount paid to a beneficiary from a RESP to help finance the cost of an eligible post-secondary education. EAPs are limited to $5,000 for beneficiaries enrolled full-time and $2,500 for beneficiaries enrolled part-time in respect of the first 13 consecutive weeks of enrollment in a 12-month period.

Budget 2023 proposes to amend the ITA to permit EAP withdrawals of up to $8,000 for beneficiaries enrolled in full-time programs, and up to $4,000 for beneficiaries enrolled in part-time programs in respect of the first 13 consecutive weeks of enrollment.

Allowing divorced or separated parents to open joint RESPs

Currently, only spouses or common-law partners can be joint owners of a RESP. Parents who opened a joint RESP prior to their divorce or separation can maintain this plan afterwards but new joint RESP plans are unable to be opened. Budget 2023 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.

These changes would come into force on March 28, 2023.

Registered disability savings plan

A registered disability savings plan (RDSP) is a savings plan intended to help parents and others save for the long-term financial security of a person who is eligible for the disability tax credit. Where the capacity of an individual who is 18 years of age or older is in doubt, the RDSP plan holder must be that individual’s guardian or legal representative as recognized under provincial or territorial law.

Currently, a temporary measure exists that is legislated to expire on Dec. 31, 2023, which allows a qualifying family member, who is a parent, spouse or common-law partner, to open an RDSP and be the plan holder for an adult whose capacity to enter into an RDSP contract is in doubt, and who doesn’t have a legal representative.

Budget 2023 proposes to extend the qualifying family member measure by three years, to Dec. 31, 2026. A qualifying family member who becomes a plan holder before the end of 2026 could remain the plan holder after 2026.

Budget 2023 also proposes to broaden the definition of ‘qualifying family member’ to include a brother or sister of the beneficiary who is 18 years of age or older. This proposed expansion of the existing qualifying family member definition would apply as of royal assent of the enabling legislation and be in effect until Dec. 31, 2026. A sibling who becomes a qualifying family member and plan holder before the end of 2026 could remain the plan holder after 2026.

General anti-avoidance rule

The general anti-avoidance rule (GAAR) in the ITA is intended to prevent abusive tax avoidance transactions. If abusive tax avoidance is established, the GAAR applies to deny the tax benefit created by the abusive transaction.

A consultation on various approaches to modernizing and strengthening the GAAR has recently been conducted. A consultation paper released last August identified several issues with the GAAR and set out potential ways to address them. The following proposal considers issues raised in the paper considering stakeholder feedback.

Budget 2023 proposes to change the GAAR by making the following amendments:

> **Preamble**: a preamble would be added to the GAAR to help address interpretive issues and ensure that the GAAR applies as intended.

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. This is consistent with the standard used in many modern anti-avoidance rules and strikes a reasonable balance, as it would apply to transactions with a significant tax avoidance purpose but not to transactions where tax was simply a consideration.

Economic substance: a rule would be added to the GAAR so that it better meets its initial objective of requiring economic substance in addition to literal compliance with the words of the ITA. Currently, in case law, economic substance isn't viewed as a primary indicator of abusive tax avoidance.

Penalty: a penalty would be introduced for transactions subject to the GAAR, equal to 25% of the amount of the tax benefit.

Reassessment period: a three-year extension to the normal reassessment period would be provided for GAAR assessments, unless the transaction had been disclosed to the Canada Revenue Agency.

The government is interested in stakeholders' views on these proposals and is keeping the consultation period open until May 31, 2023. Following this period of consultation, the government intends to publish revised legislative proposals and announce the application date of the amendments.

Tax measures that were not addressed in the budget

While widely speculated to be included in the budget, the following tax measures were not addressed:

- An increase in the capital gains inclusion rate
- Measures that broadly target capital gains planning
- A wealth tax

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