PO Box 19
2443 Eastern Shore Road
Port Medway, NS, B0J 2T0

(902) 350-3023

jconrad@conradtaxconsultancy.ca
conradtaxconsultancy.ca

2023 FEDERAL BUDGET RELEASE

OVERVIEW

The Honourable Chrystia Freeland, P.C., M.P. delivered Canada's 2023 Federal Budget on March 28th, 2023, which includes various proposed legislative changes to the Income Tax Act, Canada ("ITA"). Below is our analysis and commentary on what we consider the three most pertinent income tax changes included in Budget 2023, being Alternative Minimum Tax, the General Anti-Avoidance Rule and Intergenerational Business Transfers.

ALTERNATIVE MINIMUM TAX ("AMT")

Purpose of the changes

Budget 2023 aims to revise the current AMT regime to better target high-income individuals.

Effective date of changes

The changes are intended to be effective for taxation years beginning after 2023; therefore, the actual legislative amendments will likely not be released until late summer or early fall of this year.

Summary of changes

In reference to the budget commentary, legislative changes are proposed as follows:

- Increase the capital gains inclusion rate for the purposes of calculating AMT from 80% to 100%; however, capital gains eligible for the Lifetime Capital Gains Exemption ("LCGE") will remain at a 30% inclusion rate.

- Include 100% of the benefit associated with employee stock options vs. the current treatment which only includes 50% if the taxpayer is otherwise entitled to a deduction under paragraph 110(1)(d) of the ITA.

- Include 30% of capital gains on donations of publicly listed securities vs. the current inclusion rate of NIL.

- Disallow 50% of various deductions (*NOTE – An exhaustive list can be found in the detailed budget commentary, but it should be noted the list includes some common deductions such as employment expenses, moving expenses, childcare expenses, deduction for GIS, etc.*)

- Reduce the credit from AMT for non-refundable tax credits from 100% to 50%.

- Increase the AMT base exemption from $40,000 to the start of the fourth federal bracket, being approximately $173,000 for 2024.

- Increase the Federal AMT rate from 15% to 20.5%, which will also result in an increase to the Provincial AMT rate since it is calculated as a percentage of Federal AMT.

Impact of changes

In consideration of the changes outlined above, it should be noted that each taxpayer's specific situation will determine whether these changes will increase or decrease the AMT assessed on their return.

The most common situation causing AMT is claiming of the LCGE by a taxpayer. In applying the changes proposed by Budget 2023, it should be noted there is no change in the inclusion rate for capital gains eligible for the LCGE and the benefit of the increase in the base exemption outweighs the cost of the rate increase to a certain level of capital gains incurred; therefore, a net reduction of AMT is possible when claiming the LCGE. However, it does depend on the amount of capital gain realized by the taxpayer. For clarity:

In situations where the gain realized is fully sheltered by the LCGE, the amount of AMT incurred should be reduced in consideration of the changes proposed by Budget 2023.

In the event a taxpayer incurred a $1M capital gain and was able to fully shelter it via the LCGE, Federal AMT would be reduced by approximately $8,000 and Provincial AMT for Atlantic Canada Provinces be reduced by approximately $4,600, for a total reduction of approximately $12,600.

However, in situations where the capital gain realized exceeds the taxpayer's LCGE, but not to an extent that AMT would not otherwise apply, the amount of AMT otherwise incurred may be increased in consideration of the changes proposed by Budget 2023.

Planning Opportunities

While in many situations, AMT does not become a permanent tax cost as a result of its recovery, it is also not uncommon for a taxpayer to have insufficient income following a disposition of their business to fully recover the AMT. Where AMT recovery is a concern, there is flexibility on the timing of a sale and the gain realized on sale is expected to be within the taxpayer's LCGE, deferring the gain to 2024 or later may be a worthwhile consideration.

To the contrary, if the gain realized on sale is expected to be in excess of the taxpayer's LCGE, there is flexibility on the timing of a sale and AMT recovery is of concern, it may be worthwhile calculating AMT under the historical and new regime to determine whether a 2023 or 2024 closing may be in the taxpayer's best interest.

GENERAL ANTI-AVOIDANCE RULE ("GAAR")

Purpose of the changes

While it is well understood that taxpayers are permitted to arrange their affairs in a tax efficient manner, GAAR is intended to prevent abusive tax avoidance transactions by denying the tax benefit associated with a transaction subject to GAAR. Budget 2023 proposes to amend GAAR to address a number of issues with GAAR outlined in an August 2022 consultation paper by expanding the breadth of its application.

Effective date of changes

Finance is currently accepting submissions with stakeholder's views on the proposals until May 31st, 2023. After the consultation period, Finance intends to publish revised legislative proposals and announce their date of application.

Summary of changes

In reference to the budget commentary, Finance is proposing the following changes to GAAR:

- Introduction of a preamble – Intended to ensure GAAR applies as intended, which Finance has stated would include that GAAR is intended to apply regardless of whether or not the tax planning strategy used to obtain the tax benefit was foreseen.

- Changing the avoidance transaction standard – The current threshold for GAAR is that obtaining the tax benefit must be the "primary purpose" whereas Finance proposes the threshold be reduced to "one of the main purposes".

- Introducing an economic substance rule – Have GAAR consider economic substance as one of the factors in determining whether there is a "misuse or abuse".

- Introducing a penalty – Impose a penalty equal to 25% of the tax benefit received.

- Extending the reassessment period – Extend the ordinary assessment window by three years unless the transaction has been disclosed to Canada Revenue Agency.

Impact of changes

The proposed changes to GAAR, if imposed, would substantially increase its breadth of application, which would in turn increase the risk of its application to transactions intended to obtain a tax benefit. If implemented as proposed, could this be the end of surplus stripping and similar types of transactions? At this point, all we can do is wait and see!

INTERGENERATIONAL BUSINESS TRANSFERS (BILL C-208)

Purpose of the changes

Various changes to section 84.1 of the ITA were imposed as a result of Bill C-208; however, Finance has expressed concern that these changes do not require an actual transfer of the business to the next generation (IE – parents can continue to control, no require for children's involvement, etc.). Budget 2023 proposes to narrow the focus of the changes imposed by Bill C-208 to ensure only transactions resulting in an actual transfer of the business to the next generation will qualify.

Effective date of changes

The changes are intended to be effective for transactions occurring after January 1st, 2024; therefore, the actual legislative amendments will likely not be released until late summer or early fall of this year.

Summary of changes

In reference to the budget commentary, legislative changes are intended to include two transfer options, being an immediate intergenerational business transfer or a gradual intergenerational business transfer, each of which is summarized below:

<u>Immediate Intergenerational Business Transfer (3-year test)</u>

- Control - Parents immediately & permanently transfer legal & factual control (including immediate transfer of voting control shares, with all voting shares being transferred within 36 months).

- Economic Interest - Parents immediately transfer a majority of the common shares, with all common shares being transferred within 36 months.

- Management – Parents transfer management of the business within a reasonable time (36 months unless extenuating circumstances exist).

- Maintaining Control – Child(ren) retain control for at least 36 months following the share transfer.

- Engagement – A least one child remains actively involved in the business for at least 36 months following the share transfer.

<u>Gradual Intergenerational Business Transfer (5-to-10-year test)</u>

- Control - Parents immediately transfer legal control only (including immediate transfer of voting control shares, with all voting shares being transferred within 36 months).

- Economic Interest - Parents immediately transfer a majority of the common shares, with all common shares being transferred within 36 months. Further, a substantial reduction of the parent's economic value of their debt and equity must occur within 10 years of the initial sale (IE – 50% of the value in the case of a farm or fishing corporation and 30% in the case of a Qualified Small Business Corporation).

- Management – Parents transfer management of the business within a reasonable time (36 months unless extenuating circumstances exist).

- Maintaining Control – Child(ren) retain legal control for at least 60 months following the share transfer, or until the business transfer is complete.

- Engagement – A least one child remains actively involved in the business for the greater of 60 months following the share transfer or until the business transfer is complete.

The parent(s) and child(ren) will be required to jointly elect for the transfer to qualify as either an immediate or gradual intergenerational business transfer. Further, the child(ren) will become jointly and severally liable for any additional tax payable by their parent(s) if the transfer doesn't satisfy the legislative requirements of section 84.1 of the ITA (*NOTE – While the addition of making the child(ren) jointly and severally liable provides increased reach for Canada Revenue Agency, the parent(s) remain liable as well even though the actions of their child(ren) are beyond their control, which is punitive in our view*).

It should also be noted that in order to facilitate the ability for Canada Revenue Agency to monitor compliance of these conditions, the limitation period for reassessing the parent(s) liability for tax is proposed to be extended by three years for an immediate transfer and 10 years for a gradual transfer.

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

Impact of changes

In short, the proposed changes to section 84.1 of the ITA will restrict the types of intergenerational generations that will be permitted, increase the reporting obligations and technicalities of the transaction, and provide Canada Revenue Agency with increased reach.

While the only welcomed change from the proposed amendments is the introduction of the ten-year capital gains reserve, the proposed amendments are in line with the intention of Bill C-208 and will continue to allow true intergenerational business transfers, so progress has still been made. While we were hopeful to see some expansion to include other non-arm's length transfers, such as siblings, we are not surprised to see the Budget silent on this aspect.

Planning Opportunities

The existing provisions of section 84.1 of ITA are substantially less restrictive and technical, in addition to falling under the usual assessment windows vs. the extended assessment windows proposed. In consideration of this, completion of intergenerational transfers before the proposed amendments become effective on January 1st, 2024 may be considered advisable where appropriate.

It should also be noted that in light of the budget commentary and proposed legislative amendments, conservative planning would suggest that only true intergenerational business transfers should occur within the spirit of Bill C-208. As such, participation in transactions outside of the intended purpose of Bill C-208 could inadvertently increase the risk of the application of the GAAR, even in its current form.

ABOUT CONRAD TAX CONSULTANCY INC.

Conrad Tax Consultancy Inc. is a boutique tax firm focused on providing specialized tax solutions for individuals and business owners who value advice and its ability to allow them to better achieve their goals & objectives. We recognize the tax planning needs for each individual, business or family are unique, which is why all our planning is specifically tailored to meet the client's goals and objectives, while also providing for as much flexibility as possible to accommodate life's curveballs!

You set the goals, we do the rest!

DISCLAIMER

The above is intended to be a simplified overview of the 2023 Federal Budget proposals and should not be relied upon or acted upon as advice.

AUTHOR

Jason Conrad, CPA CA
jconrad@conradtaxconsultancy.ca
(902) 350-3023
conradtaxconsultancy.ca

SOURCES

www.budget.canada.ca