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Tax Alert – Canada

Finance releases draft legislation for 2023 budget and other measures

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 4 August 2023, the Department of Finance released for public comment several packages of draft legislative proposals, and accompanying explanatory notes, to implement most of the remaining income tax measures from the 2023 federal budget (Budget 2023), certain previously announced tax measures, and various income tax, GST/HST, and other indirect tax technical amendments.

The significant release of draft legislative proposals ahead of the August long weekend included:

- ▶ A general package of draft income tax legislative proposals relating to most of the remaining Budget 2023 measures, as well as previously announced proposals relating to the excessive interest and financing expenses limitation (EIFEL) rules and the new investment tax credits for carbon capture, utilization and storage (CCUS), and for clean technologies
- ▶ Revised draft legislative proposals relating to Canada's domestic digital services tax
- ▶ New draft legislative proposals relating to the implementation of a global minimum tax (under Pillar Two of the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting)

- ▶ A package of draft legislative proposals relating to various income tax technical amendments, including, for example, amendments relating to the stock option rules, the replacement property rules, the reduction in renunciation expenses of a resource corporation, the eligible dividend designation rules, the foreign accrual property income rules, the immediate expensing deduction, and the first home savings account and various other registered plan rules; the package also includes numerous amendments to the French version of the *Income Tax Act* (the Act) to better align it with the English version
- ▶ A package of indirect tax draft legislative proposals, including technical amendments to various GST/HST rules for financial institutions (including in respect of selected listed financial institutions) as well as for financial services, changes to the vaping product taxation framework, and changes to tax-exempt sales of motive fuels for export, as well as certain revised previously announced amendments relating to the luxury tax (e.g., in respect of an exemption for exported aircrafts and transitional relief for pre-2022 agreements), and quarterly duty remittances by licensed cannabis producers

Interested parties are invited to provide comments on the proposed amendments in the above packages of draft legislation by 8 September 2023, with the exception of the proposals relating to the global minimum tax. The comment period for the global minimum tax proposals will remain open until 29 September 2023.

The Department of Finance also announced on 4 August 2023 that it is continuing to invite stakeholder feedback on the 2022 federal budget proposals relating to substantive Canadian-controlled private corporations (CCPCs). These proposed rules expand the tax treatment of investment income earned and distributed by CCPCs to corporations that are in substance CCPCs and eliminate the tax-deferral advantage for investment income earned by CCPCs (and, potentially, substantive CCPCs) through controlled foreign affiliates, applicable for taxation years ending (tax treatment expansion) or beginning (tax-deferral elimination) on or after 7 April 2022.

The following is a summary of the income tax measures included in the general package of draft legislative proposals. The other packages of draft legislative proposals may be discussed in one or more separate upcoming tax alerts.

Business and administrative measures

Measures from Budget 2023 and the 2022 Fall Economic Update

- ▶ **Rate reduction for zero-emission technology manufacturers** - Extension of the temporary reduction in corporate income tax rates for zero-emission technology manufacturing and processing income by three years, so that the reduced rates will begin to be phased out for taxation years beginning in 2032 and will be fully phased out for taxation years beginning after 2034 (instead of being phased out from 2029 to 2031 under the existing schedule). In addition, eligible activities for purposes of the rate reduction are expanded to include certain nuclear manufacturing and processing activities – namely, manufacturing of nuclear energy equipment, processing of nuclear fuels and heavy water, and manufacturing of nuclear fuel rods – effective for taxation years beginning after 2023.

- ▶ **Tax on repurchases of equity** - Introduction (with some legislative modifications since its release on 28 March 2023) of a 2% tax on the net value of share repurchases by public corporations in Canada, subject to a de minimis rule and applicable in respect of repurchases and issuances of equity that occur after 2023. The tax applies to Canadian resident corporations with shares listed on a designated stock exchange (excluding mutual fund corporations), as well as to real estate investment trusts (REITs), specified investment flow-through (SIFT) trusts, SIFT partnerships that have units listed on a designated stock exchange, and certain other publicly traded entities that would be SIFT trusts or SIFT partnerships if their assets were located in Canada. Certain exceptions to the scope of the tax apply, including for debt-like preferred shares and units (referred to as “substantive debt”) meeting certain conditions and for shares or units that are issued or cancelled as part of certain types of corporate reorganizations and acquisitions. The tax also does not apply to equity repurchases of less than \$1 million in a taxation year (prorated for short taxation years). Certain anti-avoidance rules also apply.
- ▶ **Intergenerational share transfers** - Amendments (with some legislative modifications since their release on 28 March 2023) to ensure that the exception to the anti-surplus stripping rules in section 84.1 for certain intergenerational share transfers – which was enacted by private member’s Bill C-208, *An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)*, applies only to genuine intergenerational business transfers, effective for transactions that occur on or after 1 January 2024. Specifically, new conditions are added so that the exception will apply only to an “immediate intergenerational business transfer,” involving a three-year test based on arm’s length sales terms, or a “gradual intergenerational share transfer,” involving a 5-to-10-year test based on traditional estate freeze characteristics. In addition, a joint election will be required to be made by the transferor and transferee, and the reassessment period of the transferor with respect to a section 84.1 tax liability will be extended by three years for an immediate business transfer and by 10 years for a gradual business transfer. A 10-year capital gains reserve will also be available for intergenerational share transfers that satisfy the conditions.
- ▶ **Investment tax credit for clean technologies** - Introduction of a new 30% refundable investment tax credit for eligible investments in clean technology equipment, applicable for eligible property that is acquired and becomes available for use on or after 28 March 2023. The credit will be phased out for property that becomes available for use after 2033. Specifically, the credit is reduced to 15% in 2034, and is fully phased out in 2035. The credit rate is also reduced by 10 percentage points if certain labour conditions are not met (see “Labour requirements for certain investment tax credits” below).
- ▶ **Changes to the investment tax credit for CCUS** - Amendments to the proposed refundable investment tax credit for CCUS, which is described below under “Outstanding measures released as draft legislation on 9 August 2022” and applicable for eligible expenses incurred after 2021 and before 2041. The additional amendments, as announced in Budget 2023, include the expansion of eligible equipment to include dual-use equipment that produces heat or electrical power (or a combination of the two) or uses water, and is used in support of a CCUS project as well as another process (provided it otherwise meets the conditions of the credit); the addition of British Columbia to the list of designated jurisdictions for dedicated geological storage; validation of concrete storage requirements by an accredited third party (rather than obtaining approval from Environment and Climate Change Canada);

changes relating to the treatment of eligible refurbishment costs (i.e., the introduction of a CCUS refurbishment tax credit as part of the investment tax credit for CCUS); changes relating to recovery of the credit; and clarification of the interaction of this credit with other government assistance. Rules related to knowledge sharing and climate risk disclosure are also included in the draft legislative proposals (with some legislative modifications since their release on 28 March 2023). Certain labour requirements also apply (see below).

- ▶ **Labour requirements for certain investment tax credits** - Introduction of labour conditions, including prevailing wage and apprenticeship requirements, for purposes of the new investment tax credits for clean technologies and for CCUS, applicable in respect of specified property prepared or installed on or after 1 October 2023. To receive the maximum tax credit rates under these investment tax credits, businesses are required to pay a total compensation package that equates to the prevailing wage (based on union compensation from the most recent, widely accepted multi-employer collective bargaining agreement or corresponding project labour agreement in the jurisdiction) and ensure that at least 10% of tradesperson hours worked are performed by registered apprentices in Red Seal trades. If these labour requirements are not met, the maximum applicable credit rate is reduced by 10 percentage points.
- ▶ **Critical mineral exploration tax credit and flow-through share regime** - Expansion of the critical mineral exploration tax credit and flow-through share regime to include eligible expenses related to exploration and development activities for lithium from brines. Eligible expenses related to lithium from brines made on or after 28 March 2023 will qualify as Canadian exploration expenses and Canadian development expenses.
- ▶ **Definition of credit union** - Elimination of the revenue test under the definition of “credit union” that is included in the Act and used in the *Excise Tax Act* (for GST/HST purposes), so that credit unions that earn more than 10% of their revenue from sources other than specified sources (such as interest income from lending activities) are no longer excluded from the definition, applicable as of 1 January 2016. This amendment is intended to accommodate how most credit unions currently operate – as full-service financial institutions offering a comprehensive suite of financial products and services.
- ▶ **General anti-avoidance rule (GAAR)** - Introduction (with some legislative modifications since their release on 28 March 2023, notably to take into consideration the recent Supreme Court of Canada decision in *Deans Knight Income Corporation v The King*, 2023 SCC 16)¹ of various amendments to modernize and strengthen the GAAR, including:
 - ▶ **Preamble** - A preamble is added to the GAAR in order to help address interpretive issues and ensure that the GAAR applies as intended, by setting out some key considerations relating to the GAAR’s intended purpose and operation; the Department of Finance cautions that the preamble does not form a part of the GAAR analytical framework.
 - ▶ **Avoidance transaction** - The threshold for the avoidance transaction test is reduced from a “primary purpose” test to a “one of the main purposes” test.

¹ For more information on this Supreme Court of Canada decision, see EY Tax Alert 2023 Issue No. 23, [Supreme Court of Canada applies GAAR in Deans Knight](#).

- ▶ **Economic substance** - An economic substance test is added to the GAAR and is to be considered at the “misuse or abuse” stage of the GAAR analysis. A significant lack of economic substance is presumed to indicate abusive tax avoidance (it is presumed to frustrate the rationale of the provision (or provisions) relied upon or circumvented); however, this presumption may be rebutted in appropriate circumstances.
- ▶ **Penalty** - Transactions subject to the GAAR will be subject to a penalty equal to 25% of the amount of the tax benefit. The penalty may be avoided if the transaction is disclosed to the CRA, under the mandatory disclosure rules (for reportable transactions or notifiable transactions) or voluntarily (see below). An exception from the penalty is also provided if it can be demonstrated that the taxpayer had relied upon current case law or CRA administrative guidance in reasonably concluding that the GAAR would not apply to a transaction (or series of transactions) at the time it was entered into. A reduction of the penalty may also be provided if the gross negligence penalty under paragraph 163(2) of the Act applied in respect of the transaction or series.
- ▶ **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 CRA under the mandatory disclosure rules (for reportable transactions or notifiable transactions) or voluntarily (see below).

Consequential to the penalty and reassessment period changes noted above, amendments are made to the reportable transaction rules to allow for a voluntary disclosure of a transaction (or series of transactions) in circumstances where a disclosure would not otherwise be required. The GAAR amendments apply to transactions that occur after 2023, except that the preamble, the optional disclosure, and reassessment period amendments will apply on royal assent.

For more information on the above-noted 2023 federal budget measures, see EY Tax Alert 2023 Issue No. 20, [Federal budget 2023-24](#).

Measures released as revised draft legislation on 3 November 2022

- ▶ **Excessive interest and financing expenses limitation (EIFEL) rules** - Introduction of new earnings-stripping rules, as modified since their last release on 3 November 2022, to limit the amount of net interest and financing expenses that a corporation may deduct in computing business or property income, or taxable income, to a fixed ratio (or, where certain conditions are met and a consolidated group elects, a higher group ratio) of adjusted taxable income for the year. Adjusted taxable income is essentially taxable income adjusted to, among other things, reverse deductions for interest and financing expenses, CCA, resource expenses and terminal losses, and reverse income inclusions for interest and financing revenues, CCA recapture and recovery of certain resource expenses; adjusted taxable income thus approximates the accounting concept of earnings before interest, taxes, depreciation and amortization (EBITDA) but as determined for tax purposes. Subject to transitional rules, these rules apply in respect of taxation years beginning on or after 1 October 2023. For more information on the 3 November 2022 version of the proposals, see EY Tax Alert 2022 Issue No. 43, [Revised EIFEL proposals](#).

Outstanding measures released as draft legislation on 9 August 2022

- ▶ **Investment tax credit for CCUS** - Introduction of a refundable tax credit for businesses that incur qualified expenditures related to CCUS (qualified CCUS expenditures) after 2021 and before 2041. As described above under “Changes to the investment tax credit for CCUS,” certain modifications have been announced to the credit since the previous release of draft legislation on 9 August 2022 and incorporated into the 4 August 2023 draft legislative proposals, including the separation of the credit into a cumulative CCUS development tax credit (for qualified CCUS expenditures incurred before the first day of commercial operations of a CCUS project) and a CCUS refurbishment tax credit (for qualified CCUS expenditures during the total CCUS project review period). Qualified CCUS expenditures include the cost of acquiring eligible equipment used in qualified CCUS projects. Eligible equipment includes equipment that is used solely to capture, transport, store or use carbon dioxide (CO₂) as part of a qualified CCUS project and is situated in Canada. This equipment is included in new CCA classes 57 and 58, which have 8% and 20% declining-balance-basis CCA rates, respectively, and is eligible for enhanced first-year depreciation under the accelerated investment incentive. For qualified CCUS expenditures incurred after 2021 and before 2031, credit rates are 60% for qualified carbon capture expenditures used to capture carbon directly from ambient air, 50% for other qualified carbon capture expenditures and 37.5% for qualified carbon transportation, storage or use expenditures. These credit rates are reduced by half for eligible expenses incurred after 2030 and before 2041. The tax credit may be claimed in respect of the taxation year in which qualified CCUS expenditures are incurred, regardless of when the related equipment becomes available for use. The extent to which the tax credit will be available is also dependent on the projected eligible use percentage of the CO₂ being captured; new Part XII.7 recovery taxes may also be imposed to recoup any excess tax credits claimed where the projected eligible use percentage is not met at the end of each of the four project periods. Also, the credit rate is reduced by 10 percentage points if certain labour conditions are not met (see “Labour requirements for certain investment tax credits” above).
- ▶ **Exploration and development expenses relating to CCUS** - Introduction of new CCA classes 59 and 60 for intangible exploration expenses and development expenses related to the storage of captured carbon. Class 59 provides a 100% rate and applies to property acquired after 2021 for the purpose of determining the existence, location, extent or quality of a geological formation to permanently store captured carbon in Canada, including property acquired as a result of undertaking environmental studies or community consultations. Class 60 provides a 30% declining-balance rate and generally applies to property acquired after 2021 for the purposes of drilling, converting or completing a well in Canada for the permanent storage of captured carbon, or for monitoring pressure changes (or other phenomena) in a geological formation in which captured carbon is permanently stored, as well as various rights, licenses or privileges acquired for related purposes.

Personal and trust measures

Measures from Budget 2023 and the 2022 Fall Economic Update

- ▶ **Employee ownership trusts** - Introduction of new rules, as modified since their release on 28 March 2023, to facilitate the use of employee ownership trusts (EOTs) to acquire and hold shares of a CCPC for the benefit of the corporation's employees. Among these rules, the capital gains reserve is extended to 10 years for qualifying business transfers to an EOT or to another CCPC that is controlled and wholly owned by an EOT, an exception to the current shareholder loan rules is created to extend the repayment period to 15 years for a loan used by an EOT to purchase shares in a qualifying business transfer, and EOTs are exempted from the 21-year deemed disposition rule that applies to certain trusts. In general terms, an EOT is a Canadian resident trust that holds a controlling interest in a qualifying business where shares are held for the benefit of employee beneficiaries and distributions are made to employee beneficiaries under a distribution formula that considers only an employee's length of service, remuneration and hours worked. Various other conditions for a trust to qualify as an EOT also apply (e.g., with respect to an EOT's trustees, beneficiaries and assets). These rules apply as of 1 January 2024.
- ▶ **Alternative minimum tax (AMT) for high-income individuals** - Various changes to the AMT, including broadening of the AMT base by further limiting tax preference items, increasing the basic exemption amount and the AMT rate, and expanding eligibility for the general AMT exemption, effective for taxation years beginning after 2023. Notable changes to the AMT base include:
 - ▶ Increasing the AMT capital gains (and capital loss) inclusion rate from 80% to 100% and decreasing it from 80% to 50% for allowable business investment losses
 - ▶ Removing the exception for capital gains on donated property to qualified donees, so that 100% of those gains (rather than nil) are now included in the AMT base, except that a 30% inclusion rate applies to capital gains on donations of publicly listed securities
 - ▶ Disallowing 50% of certain deductions (such as deductions for moving expenses, child care expenses, certain employment expenses and carrying charges)
 - ▶ Including 100% of the benefit associated with employee stock options in the AMT base, with the exception of benefits associated with donated stock options that are now subject to a 30% inclusion rate
 - ▶ Grossing-up the amount of any capital gains deduction claimed to maintain the 30% inclusion rate (that applies under the current AMT rules) for capital gains on property eligible for the lifetime capital gains exemption
 - ▶ Limiting the deduction of non-capital loss carryforwards to 50% of the amount that may otherwise be deducted and the deduction of capital loss carryforwards to the amount that may otherwise be deducted

In addition, only 50% of non-refundable tax credits (currently allowed under the AMT rules, with some new modifications to include the disability tax credit in respect of a dependent and certain transferred credits) can be used to reduce the AMT, subject to certain exceptions. The basic exemption amount is increased from \$40,000 to correspond to the lower threshold amount of the fourth federal income tax bracket, which is indexed annually to inflation and is expected to be approximately \$173,000 in 2024. Also, the AMT rate is increased from 15% to 20.5% and the general exemption is expanded to exempt additional trusts from the AMT such as graduated rate estates (which were previously only eligible for the basic exemption amount) and trusts governed by various registered pension and registered savings plans. The length of the minimum tax carryforward is maintained at seven years and trusts that are currently exempt from the AMT continue to be exempt.

- ▶ **Retirement compensation arrangements (RCA)** - Amendments to ensure that fees or premiums paid (on or after 28 March 2023) for the purposes of securing or renewing a letter of credit (or a surety bond) for an RCA that is supplemental to a registered pension plan will not be subject to the refundable tax. Amendments are also made to allow employers to request a refund of previously remitted refundable taxes in respect of fees or premiums paid (before 28 March 2023) for letters of credit (or surety bonds) by RCA trusts, based on the retirement benefits that are paid out of the employer's corporate revenues to employees that had RCA benefits secured by letters of credit (or surety bonds). Employers would be eligible for a refund of 50% of the retirement benefits paid, up to the amount of refundable tax previously paid.

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