

Federal budget briefing 2023

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The Honourable Chrystia Freeland, Deputy Prime Minister and Minister of Finance, tabled the Liberal government's third budget since the COVID-19 pandemic began. Budget 2023 includes draft legislative amendments following the public consultation on the general anti-avoidance rule (GAAR), further details about the share buyback tax, a new rule denying dividend received deduction for financial institutions and additional details on certain clean technology investment tax credits proposed in [Budget 2022](#) and the 2022 Fall Economic Statement as well as the expansion of measures in this space against the backdrop of keeping Canada competitive with the U.S.

Budget 2023 also provides general economic and fiscal information and projections, as well as updates on some previously announced tax measures and international tax reform under Pillar One and Pillar Two.

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Report from Osler Special Advisor Stephen Poloz, former Governor of the Bank of Canada

Federal budget 2023: shifting to offense

The latest federal budget lands in the most difficult context in a generation. The world is experiencing major geopolitical shifts in the orbits of both China and Russia, as well as the biggest outbreak in inflation in 50 years, and the pandemic has left a public debt legacy comparable to that of World War II. Meanwhile, Canada is trailing its peers in business investment, in productivity and in economic growth per person, and the U.S. *Inflation Reduction Act* represents yet another major disturbance in our competitive landscape.

Since its first budget in 2016, this government has portrayed itself as tackling some of the fundamental weaknesses in Canada's economy. These include addressing rising income inequality, strengthening childcare to boost labour force participation, raising immigration targets, negotiating trade agreements and attempting to balance all this with a future with net-zero carbon emissions.

From the beginning, the role of some sort of fiscal anchor has been acknowledged. The governing framework that was adopted was a minimalist one, where the federal debt-to-GDP ratio would be stable or declining. This is just like a private sector company with headline revenue growth deciding what level of debt it can sustain, and then building an optimal capital structure around that. This arithmetic meant that the government could run a persistent fiscal deficit of around 1% of GDP; this would of course keep adding to the stock of government debt, but at a rate lower than the growth in the economy, so that the debt-to-

GDP ratio would gently decline. Running a persistent deficit gave the government room to introduce new initiatives each year that would help address Canada's structural weaknesses.

In any case, Canada was in an enviable fiscal situation when the pandemic came along. In the spring of 2020, the worst-case scenario that policymakers had in mind was one where government revenues would fall, government spending would surge and the debt-to-GDP ratio would double, from around 30% to 60% of the economy. This possibility seemed astonishing at the time, but the first shutdown caused Canada's GDP to fall by 20%, just by way of illustration, and no one knew how long it might take to get vaccines developed and allow people to return to normal economic behavior. Even so, the possibility that government indebtedness could rise to 60% reminded us of a meaningful precedent: it would be far lower than the 66% Canada hit in 1994. Therefore, we knew that, challenging as it might be, such a rise in debt could be managed for the simple reason that it had been managed in the past.

Although that was the worst-case scenario, the government's pandemic budget projected a rise in the debt ratio from 30% to about 50%. As everyone now knows, however, the economy responded well to the programs, vaccines came along quite rapidly and the fiscal plan outperformed expectations. According to Budget 2022, the debt ratio peaked at 47.5% in fiscal 2020, and would decline by around 1% per year from there. Behind this revision was a fiscal windfall of about \$80 billion over five years relative to Budget 2021 due to a stronger-than-expected economy. The government deployed around half of this windfall to new programs.

Last November, the Fall Economic Statement added a new chapter to this story, which rhymes with the previous one. The economy again has delivered more economic growth than assumed in Budget 2022, but most importantly, it has also delivered much higher inflation. In November it looked like Budget 2023 would begin with another major fiscal windfall on the table, something like \$94 billion over five years.

This is where an exclusive focus on budget deficits can be misleading. Budget deficits are net concepts being influenced by many things on both sides of the equation. A lower deficit may appear "prudent" in some sense, but if a major fiscal windfall is simply spent, leaving the fiscal deficit as before, it can hardly be construed as prudent. For this reason, it is helpful to bear in mind the level of government spending in the economy. In the pre-pandemic economy, federal spending amounted to around 14.5% of the economy, and even with the ambitious plans of this government it was envisioned that it would only drift up to around 15%. It of course ballooned during the pandemic, doubling to 28%, eased to 19% in fiscal 2021, and then to about 16% in fiscal 2022. In Budget 2022 it was projected to remain close to 15%, not unlike the various pre-pandemic budgets. Even so, this implies a pretty big boost to the spending baseline from \$390 billion in fiscal 2019 to \$452 billion in fiscal 2022.

Which brings us to Budget 2023. In preparing the budget, the government faced many new fiscal demands, including the already-agreed boost to healthcare transfers (not completely new fiscally, as placeholders were in the plan), boosting defense spending, new housing programs and, of course, the big question mark: choosing ways to create a level playing field in response to the U.S. *Inflation Reduction Act*.

Nevertheless, the government has expressed a desire not to add further to inflation pressures in the economy. Arguably, that horse has already left the barn. The economy showed no growth in the fourth quarter of 2022, business and housing investment have been negative for three quarters in a row and inflation is trending down meaningfully. If the government had reduced its fiscal stimulus a year ago, it would have meant fewer inflation pressures and a lower profile for Bank of Canada interest rates, and therefore less collateral damage to the economy — a missed opportunity to benefit many Canadians. It will be much

harder to argue now that fiscal policy is still contributing to above-normal inflation and interest rates. Indeed, a budget focused on “investments” arguably boosts the supply side of the economy — the childcare program or the completion of the TransMountain pipeline would fall into this category — which is not fiscal stimulus really, but more a disinflationary policy aimed at expanding economic capacity.

In the event, Budget 2023 lays out continuing deficits through the five years starting in fiscal 2022 (which will soon end). Fiscal 2022 will deliver a lower deficit than estimated a year ago (\$43 billion versus \$53 billion) but a higher deficit in every year from now on. Cumulatively, an additional \$12 billion will be tacked onto the federal debt load compared to Budget 2022. This looks pretty minor in the grand scheme of things. However, recall that the Fall Economic Statement showed a fiscal windfall over those same five years of \$94 billion due to stronger economic growth and higher inflation. Because the economy slowed unexpectedly in late 2022, the economic update on which Budget 2023 is based generates a reduced fiscal windfall, relative to Budget 2022, of \$78 billion over five years. Part of this windfall must now be allocated to higher debt service costs, which have risen due to the rapid increase in interest rates since Budget 2022 was tabled. Indeed, over five years, higher debt costs of about \$40 billion have been built in. This leaves a fiscal windfall of approximately \$38 billion spread over five years. Accordingly, even with no change in the deficit line, there was roughly \$38 billion in fiscal capacity sitting on the table. As it happens, this roughly covers the government’s new expenditure increases of \$35 billion over five years, two-thirds of which is going to health and dental care.

The anchor in the framework remains the federal debt-to-GDP ratio. For the current fiscal year just about to end, the deficit will turn out to be lower than expected last year, so the debt ratio is estimated at 42.4% versus 45.1% predicted in last year’s budget. This stronger starting point carries through the next four years, with the ratio averaging 42.5% and reaching 41.1% in fiscal 2026 (and slipping below 40% in year six). This is to be compared with Budget 2022’s estimates averaging 43.5% and landing at 41.5% in fiscal 2026. In short, Budget 2023 achieves a very slightly lower profile for debt as a share of the economy, but at least it is in the direction of building future fiscal resilience.

But how do we judge the net impact of the budget on the economy? One way to judge this is to look at government spending as a share of the economy, which is set to rise by more than one percentage point on average over five years compared to last year’s budget. For example, spending in the fiscal year just ending goes from \$452 billion in last year’s budget to \$470 billion. Indeed, on average over five years, spending is \$28 billion higher, every year. Additional spending equal to 1% of GDP could make a meaningful difference to the macroeconomy, but it depends on the ways in which it is delivered and when it lands. How the budget tips the balance of risks of future inflation will depend on several considerations, including the state of the economy when the new spending hits and the extent to which the government’s initiatives contribute to future capacity growth in the Canadian economy. Given that the demand side of the economy is already slowing sharply and most of the effects of last year’s increases in interest rates have yet to appear, it is even possible that Budget 2023 will help improve the odds of a soft landing in the economy, by buffering demand and boosting supply. Given the complexity of the situation, and the uncertainty around the outlook, it is simply too close to call.

Business income tax measures

Significant amendments to the general anti-avoidance rule

Budget 2023 introduces sweeping legislative proposals to amend the general anti-avoidance rule (GAAR). The GAAR is a rule in the *Income Tax Act* (Canada) (ITA) that is designed to negate

tax benefits arising from “abusive” tax avoidance transactions. These are transactions that satisfy the technical requirements of the ITA, but are found to be contrary to the spirit or underlying policy of the legislation or its specific provisions.

The application of the GAAR is premised on three requirements: there has to be both a “tax benefit” and an “avoidance transaction,” which is generally a transaction that is undertaken primarily for tax purposes, and it must be demonstrated that the avoidance transaction, or the series of transactions of which it is a part, results in a misuse or abuse of particular provisions of the ITA or of the legislation as a whole (or other applicable tax enactments).

The proposals in Budget 2023 stem from a [consultation paper](#) that was released in August 2022 as part of a public consultation process on modernizing Canada’s anti-avoidance rules, including the GAAR. Osler’s submissions in response to the consultation paper are [available here](#).

The proposed amendments would introduce a novel preamble, a modified threshold for identifying an avoidance transaction and a new “economic substance” test to be considered in the determination of whether there is misuse and abuse. The proposals would also impose a penalty and extend the normal reassessment period in certain circumstances.

The government has invited interested parties to provide views on the proposals by May 31, 2023. Following this consultation, the government intends to publish revised proposals and announce the effective date of the amendments.

Preamble

The proposed legislation contains an introductory provision about the role of the GAAR that the government suggests would help to address interpretive issues and ensure that it applies as intended. A statement of this nature contained in the legislation itself is a departure from the norm. The preamble declares that the GAAR

1. applies to deny tax benefits resulting from an avoidance transaction’s misuse of the provisions of the ITA or an abuse of the ITA as a whole (or other applicable tax enactments), while allowing taxpayers to obtain tax benefits contemplated by the relevant provisions
2. strikes a balance between the need for taxpayer certainty in planning their affairs and the government’s responsibility to protect the tax base and fairness of the tax system
3. can apply regardless of whether a tax strategy is foreseen

Changing the avoidance transaction standard

The proposed legislation would change the standard for determining whether a transaction is an avoidance transaction. Currently, an avoidance transaction is defined as a single transaction or one that is a part of a series of transactions where the transaction or the series results directly or indirectly in a tax benefit, unless the transaction is carried out “primarily” for *bona fide* purposes other than to obtain the tax benefit.

The proposals would replace this primary purpose test with a test that is based on whether “one of the main purposes” of a transaction (whether alone or as part of a series) was to obtain the tax benefit.

Budget 2023 states that the intended result is for the GAAR to apply to a transaction with a “significant tax avoidance purpose” but not to one where tax was simply a consideration.

Economic substance rule for misuse and abuse

The proposed legislation introduces a new economic substance test when considering the application of the GAAR. The measure is stated to be in response to GAAR jurisprudence that, according to the government, has established a more limited role for economic substance. The test itemizes the following three factors that, in the government’s view, tend to demonstrate a lack of economic substance:

1. All or substantially all of the opportunity for gain or profit and risk of loss of the taxpayer (taken together with those of non-arm’s length persons) remains unchanged, including because of a circular flow of funds, offsetting financial positions or the timing between steps in the series.
2. It is reasonable to conclude that, at the time the transaction was entered into, the expected value of the tax benefit exceeded the expected non-tax economic return (which excludes both the tax benefit and any tax advantages connected to another jurisdiction).
3. It is reasonable to conclude that the entire, or almost entire, purpose for undertaking or arranging the transaction or series was to obtain the tax benefit.

It is notable that under the proposed legislation these factors are not exhaustive when determining whether economic substance is lacking.

The proposal indicates that an avoidance transaction that is “significantly lacking” in economic substance “tends to indicate” that a transaction or series of transactions results in a misuse or abuse.

Despite the breadth of the proposed changes, Budget 2023 clarifies that a lack of economic substance will not always mean that a transaction is abusive and that it is still necessary to examine the object, spirit and purpose of the provisions to determine whether there has been misuse or abuse. It further confirms that where a transaction has economic substance, the existing GAAR jurisprudence would continue to be relevant.

Finally, Budget 2023 states that the proposal is not intended to supplant the existing approach to Canadian tax law, which respects the legal form of transactions. Also, the proposed new test does not require an enquiry into what the economic substance of a transaction actually is.

It remains to be seen whether subjective terms such as “significantly lacking”, “tends to indicate” and “almost entire” will be retained in the final legislation following the consultation period and, if they are retained, how such undefined concepts would ultimately be interpreted by the courts.

Adding a penalty

The proposed legislation introduces a penalty for transactions subject to the GAAR equal to 25% of the amount of the tax benefit unless the transaction has been disclosed under the mandatory reporting rules (including under prior proposals to expand those rules and under a new proposal to allow taxpayers to voluntarily report transactions, pursuant to which

taxpayers can file an information return containing the same information as required for mandatorily reportable transactions). The proposed legislation provides that the amount of a tax benefit that involves a tax attribute that has not yet been used to reduce tax is deemed to be nil for purposes of calculating the penalty.

Extending the reassessment period

The proposed legislation would provide a three-year extension to the normal reassessment period for GAAR assessments, unless the transaction had been disclosed to the CRA under the proposed expanded mandatory disclosure rules in the ITA (or under the new voluntary reporting rule). The government suggests this change is necessary to reflect the complexity of many GAAR transactions, along with the difficulties in detecting them.

Share buyback tax

Budget 2023 sets out proposed legislation to implement the government's previously announced 2% tax on the annual net value of share repurchases by public corporations. This measure is inspired by and is broadly similar to a U.S. measure taxing share buybacks at a 1% rate, in force since January 1, 2023.

The measure would apply to Canadian-resident corporations with shares listed on a designated stock exchange (but excludes mutual fund corporations). The measure also applies to certain entities with units listed on a designated stock exchange, such as real estate investment trusts, specified investment flow-through (SIFT) trust and SIFT partnerships. In addition, publicly traded entities that would be SIFT trusts or SIFT partnerships if their assets were located in Canada would be subject to the tax.

The tax is 2% of the difference between the total fair market value of equity redeemed, acquired or cancelled by an entity and the total fair market value of equity issued in the year. Issuance and cancellation of non-participating debt-like preferred shares and units, as well as the issuance and cancellation of shares or units in certain corporate reorganizations and acquisitions (including certain specified amalgamations, liquidations, and share-for-share exchanges), are excluded.

The measure has a *de minimis* rule that ensures no tax is payable if equity repurchases are less than \$1 million (on a gross basis) for a taxation year.

The measure also contains rules to deem the acquisition of equity by affiliates to have been a repurchase by the entity itself (with exceptions for certain equity-based compensation arrangements and ordinary course acquisitions by registered securities dealers) and anti-avoidance rules that address certain transactions undertaken to avoid payment of the tax.

The tax applies in respect of repurchases and issuances of equity on or after January 1, 2024. Entities that redeem, acquire or cancel equity will be required to file an annual return in prescribed form.

Denial of dividend received deduction for financial institutions

Budget 2023 proposes to deny a deduction to financial institutions in respect of dividends received on shares of taxable Canadian corporations where the shares are "mark-to-market property" of the financial institution.

Under the ITA, taxable dividends received by a corporation resident in Canada from a taxable

Canadian corporation are generally deductible. In the absence of such a deduction, the imposition of a second corporate tax would result in the taxation of the same income twice.

The “mark-to-market” rules were introduced in the 1994 federal budget to apply to certain securities held by financial institutions. The rules require shares and certain debt obligations to be marked to market at the end of each year, with any mark-to-market gain or loss being recognized on income account.

Budget 2023 states that the policy behind the dividend received deduction conflicts with the policy behind the mark-to-market rules, in the sense that gains on mark-to-market shares are taxed as business income but dividends received on such shares are eligible for the intercorporate dividend deduction and are excluded from income. This curious proposition conflates the concepts of income characterization and income recognition, suggesting that the character of a particular type of income may be sufficient to displace the longstanding principle of integration that prevents corporate income from being subject to multiple taxation. It also ignores the fact that the ITA already contains rules that apply to dividends received on shares held as mark-to-market property. The presence of the existing provisions confirms that, as a policy matter, the mark-to-market rules and dividend received deduction are intended to co-exist. It appears the policy conflict identified by the Department of Finance in Budget 2023 has been very recently divined.

The measure would apply in respect of dividends received after 2023.

Expanded tax support for clean technology and green energy

Budget 2023 includes further details on, and in certain cases expands, previously announced investment tax credits (ITC) and other measures introduced by the Government of Canada to support the development of the clean technology and energy sectors. Budget 2023 also announces two new ITCs targeting clean electricity and clean technology manufacturing. These measures arrive against the backdrop of the U.S. *Inflation Reduction Act*, which introduced similar measures, and in the government’s view allow Canada to remain competitive.

In particular, Budget 2023 includes the following measures:

- expansion of the ITC for Clean Technologies announced in the 2022 Fall Economic Statement (2022 FES) to include geothermal energy
- further details on the ITC for Clean Hydrogen announced in the 2022 FES, including the carbon intensity thresholds that will apply to determine the applicable ITC rate
- further details and expansion of the ITC for carbon capture, utilization and storage (CCUS), including extending eligibility to certain dual-use equipment, the addition of British Columbia as an eligible jurisdiction for dedicated geological storage, extending the ITC to refurbishment costs, details on the ongoing reporting requirements and the addition of a labour requirement
- details of the labour requirements on prevailing wages and apprenticeship that will apply to certain of the ITCs
- expansion and extension of reduced tax rates for zero-emission manufacturing and processing activities announced in Budget 2021 to nuclear activities

- expansion of flow-through shares treatment and the 30% critical mineral extraction and processing tax credits to lithium from brines
- a new refundable 15% ITC for Clean Electricity
- a new refundable 30% ITC for Clean Technology Manufacturing and Processing

Expanded Clean Technologies ITC

In the 2022 FES, the government announced a 30% refundable Clean Technologies ITC, available to eligible properties that are acquired and become available for use on or after March 28, 2023. For further details of the announcement in the 2022 FES, please see the [Osler Update dated November 3, 2022](#).

In Budget 2023, the government expanded this ITC to apply to geothermal energy projects. Specifically, it would be available for equipment that generates electricity or heat energy, or both electrical and heat energy, solely from geothermal energy (which currently qualify as Class 43.1 property under subparagraph (d)(vii)).

The term of this ITC was also extended. Instead of phasing out the ITC in 2032 (as announced in the 2022 FES), the credit rate will remain at 30% for property that becomes available for use in 2032 and 2033 and will reduce to 15% in 2034. The credit is unavailable after 2034.

Further details on the Clean Hydrogen ITC

The Clean Hydrogen ITC was also announced in 2022 FES with the promise of additional details in Budget 2023, including the carbon intensity thresholds that will set eligibility for, and the rate of, this ITC. For further details of the announcement in the 2022 FES, please see the [Osler Update dated November 3, 2022](#).

The government provided details of the basic design elements of this ITC in Budget 2023.

Eligible projects and equipment

Eligible projects are limited to those that produce all or substantially all of their hydrogen from either electrolysis or natural gas, provided any emissions from the gas are abated with CCUS. The government signaled that it is open to adding other low-carbon hydrogen production processes to this credit.

The ITC is available for the cost of purchasing and installing eligible equipment, including

- equipment required to produce hydrogen from natural gas (if emissions are abated using CCUS)
- oxygen production equipment used for hydrogen production (if the CO₂ is captured by a CCUS process)
- equipment that produces heat and/or power from natural gas or hydrogen
- dual-use power or heat production equipment, if more than 50% of the energy balance is expected to be primarily used to support the CCUS process or hydrogen production

(though the ITC would be pro-rated based on the expected energy balance supporting the hydrogen production process)

Equipment that is required to convert clean hydrogen to clean ammonia would also be eligible for this credit, but at a reduced 15% rate.

The cost of CCUS equipment is not eligible for this credit. Feasibility studies, front-end engineering design studies and operating expenses are also not eligible.

The ITC is available in respect of property acquired and that becomes available for use on or after March 28, 2023.

Credit rates

The ITC rate will depend on the carbon intensity (CI) of the project, measured by the kilograms of CO₂e produced per kilogram of hydrogen produced, and meeting prescribed labour conditions. The rate schedule is as follows:

Kg CO₂e per kg of clean hydrogen	Portion of project costs claimable as credit	Portion claimable with labour conditions met
2 kg - < 4 kg	5%	15%
0.75 kg - < 2 kg	15%	25%
< 0.75 kg	30%	40%

Other notable aspects of how the CI of a project will be determined include

- The CI of a project will be reviewed based on applying the government's Fuel Life Cycle Assessment (LCA) Model to the initial design. Ongoing verification and re-assessments will be required (including upon changes to the LCA Model or significant re-design of the project).
- The CI assessment will take into account the life-cycle emissions determined from "cradle-to-gate" — that is, from upstream (input) emissions all the way through to the point where hydrogen exits the factory gate.
- Captured CO₂ that is stored in any manner other than an "eligible use" as defined for purposes of the CCUS ITC would be treated as released into the atmosphere in measuring CI. Under the current proposed CCUS ITC, this means CO₂ used in enhanced oil recovery would be treated as released.
- Power Purchase Agreements and other similar instructions to purchase clean electricity and sell electricity back to the grid will be relevant in measuring the CI. However, this will be subject to conditions that will be announced at a later date.

Further expansion of the CCUS ITC

Budget 2023 includes additional features to the CCUS ITC proposed in Budget 2022, which apply to eligible expenses incurred beginning January 1, 2022, and ending December 31, 2040.

Dual-use equipment

Budget 2022 previously provided that equipment was eligible for the CCUS Tax Credit only where its sole purpose was the support of CCUS processes. Budget 2023 expands the eligibility for the CCUS Tax Credit to dual-use equipment used for both CCUS processes and water use or heat and/or power production, so long as (a) such equipment meets all other conditions for the CCUS Tax Credit; (b) the energy balance is anticipated to be primarily used for CCUS process support or the support of hydrogen production eligible for the Clean Hydrogen ITC; and (c) in the case of power and/or heat production equipment, CO₂ emissions from such production activities will be captured or stored.

The available ITC will be calculated based on a pro-ration of the cost of eligible dual-use equipment based on the expected energy or other material balance used to support CCUS processes over the first 20 years of the project.

Eligible use – dedicated geological storage and concrete storage

Budget 2023 proposes to add British Columbia to the list of eligible jurisdictions for dedicated geological storage, which previously only included Alberta and Saskatchewan.

For concrete storage, satisfaction of the requirement that a minimum of 60% of the CO₂ injected into the concrete be mineralized and locked into the produced concrete must be verified by a qualified third party, instead of by Environment and Climate Change Canada.

Refurbishment costs

Budget 2023 expanded the CCUS ITC to apply to eligible refurbishment costs (Refurbishment ITC) that are incurred after a project commences operation. The key aspects of the Refurbishment ITC are summarized below:

- The ITC is available for costs incurred in the first 20 years of the project.
- Total eligible refurbishment costs for the first 20 years of the project would be limited to a maximum of 10% of the total pre-operation costs that were eligible for the CCUS ITC.
- Entitlement to, and the quantum of, the Refurbishment ITC are generally determined in a manner similar to the CCUS ITC.
- The credit is subject to recovery in generally the same manner as the CCUS ITC for construction costs, with certain adjustments to reflect the fact that refurbishment costs will be incurred during a shorter time frame.

Reporting requirements

Budget 2023 includes draft legislation for the knowledge sharing and climate risk disclosure requirements.

The proposed knowledge sharing requirements contemplate two types of knowledge sharing reports: annual operations knowledge sharing reports and construction and completion knowledge sharing reports. Both reports must contain information as described in the “CCUS-ITC – Technical Guidance Document” as published by the Minister of Natural Resources.

Taxpayers must prepare and submit both types of knowledge sharing report to the Minister of Natural Resources before the prescribed due date if the CCUS project (a) is expected to

incur \$250 million or more of qualifying CCUS expenditures over the project lifespan or (b) has incurred \$250 million or more of qualified CCUS expenditures before its first day of commercial operations.

Construction and completion knowledge sharing reports must be prepared for the period beginning the first day an expenditure is incurred for a qualified CCUS project until the first day of commercial operations. Annual operations knowledge reports must be prepared for the first five calendar years beginning in the year in which commercial operations begin. These knowledge sharing reports will be published online by the Department of Natural Resources. Budget 2023 proposes that failure to provide a knowledge sharing report will result in a penalty of \$2 million, payable the day after the knowledge sharing report is due.

Taxpayers who claim the CCUS Tax Credit are also required to prepare and make publicly available a climate risk disclosure report describing the climate-related risks and opportunities for the taxpayer, as well as how its governance, strategies, policies and practices contribute to achieving Canada's commitments under the Paris Agreement and its goal of net-zero emissions by 2050. There is an exception to this reporting requirement if the CCUS project has incurred, or is expected to incur, expenditures of less than \$20 million. A climate risk disclosure report must be prepared for each taxation year beginning in the year in which a taxpayer claims the CCUS tax credit and ending in the taxation year before the 21st calendar year after the taxation year in which the qualified CCUS project's commercial operations began. Failure to publish a climate risk disclosure report will result in a penalty equal to the lesser of 4% of the total of all CCUS credits claimed by the corporation in the relevant taxation year or \$1 million.

Labour requirements

Budget 2023 provides that the labour requirements discussed below are intended to apply to the CCUS Tax Credit effective on October 1, 2023. The government did not provide any further details on how the labour requirement will impact the CCUS ITCs.

Wage and labour requirements for ITCs

Similar to the U.S. *Inflation Reduction Act*, the 2022 FES indicated Canada's intention to include wage and apprenticeship requirements for the proposed Clean Technology and Clean Hydrogen Investment Tax Credits (the labour requirements).

Budget 2023 proposes a wage and apprenticeship target for labour relating to the proposed Clean Technology (except for zero-emission vehicles or low-carbon heat equipment), Clean Electricity, Clean Hydrogen and CCUS ITCs. The labour requirements apply to work performed beginning on October 1, 2023.

With respect to the wage component of the labour requirements, business owners must ensure all covered workers are paid in an amount at least equal to the relevant wage plus the value of standard benefits and pension contributions as would be provided for in an "eligible collective agreement". In provinces other than Québec, the "eligible collective agreement" is generally a comparable collective agreement for the relevant industry and type of work performed which aligns with the worker's duties and location. In Québec, the eligible collective agreements are those negotiated under relevant provincial law.

With respect to the apprenticeship component of the labour requirements, 10% of the total labour hours in the relevant taxation year by covered workers (those whose duties correspond to those performed by a journeyman in a Red Seal trade) doing work on subsidized project elements must be done by registered apprentices.

The labour requirements apply in respect of workers performing primarily physical or manual labour on project elements that are subsidized by the respective ITC; they do not apply to individuals whose duties are primarily administrative, clerical, supervisory or executive. The labour requirements apply to those engaged directly by the project owner or through contractors and subcontractors.

Failure to satisfy the labour requirements will result in a 10% rate reduction generally, and reduction to 0% during the phase-out period of the applicable credit. Details on the application of this requirement to the CCUS ITC will be announced at a later date.

A taxpayer who fails to satisfy the labour requirements will have the opportunity to correct the deficiency by paying top-up amounts (and interest) to workers and penalties to the Receiver General and will be deemed to have satisfied the labour requirements. Further details of this penalty regime will be announced in the future.

Reduced tax rates for zero-emission nuclear manufacturing and processing activities

Budget 2021 announced a temporary rate reduction for zero-emission technology manufacturers that allowed for a 50% income tax rate reduction. Budget 2023 expands the reduced tax rates for zero-emission manufacturing to manufacturers of nuclear energy equipment, processing or recycling of nuclear fuels and heavy water, and manufacturing of nuclear fuel rods. The reduced rates will apply for taxation years beginning after 2023. In addition, the reduced tax rates measure has been extended by two years and will begin to be phased out in 2032 (as opposed to 2029), with a full phase-out by 2035 (as opposed to 2032).

Flow-through shares and critical mineral exploration tax credit for lithium from brines

Budget 2023 proposes to amend the ITA to include lithium from brines as a mineral resource such that certain expenses relating to lithium from brines incurred after March 28, 2023, will be treated as eligible expenses for the purposes of (i) flow through share treatment of Canadian exploration expenses (CEE) at 100% and Canadian development expenses (CDE) at 30%. Budget 2023 also expands the eligibility for the Critical Mineral Exploration Tax Credit (CMETC) to include expenditures related to lithium from brines renounced to investors under flow-through share agreements entered into after March 28, 2023, and on or before March 31, 2027.

New Clean Electricity ITC

Budget 2023 proposes a new 15% refundable tax for eligible investments in

- 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
- stationary electricity storage systems that do not use fossil fuels in operation
- equipment for the transmission of electricity between provinces and territories

Most notably, and marking a deviation from the other ITC measures in this package, these refundable ITCs are available for expenditures on new projects and refurbishment of existing facilities and are available to both taxable and non-taxable entities (such as Crown corporations and publicly owned utilities, corporations owned by Indigenous communities and pension funds).

There is significant overlap between the projects and property eligible for the Clean Technology ITC and the Clean Electricity ITC. However, where a taxpayer is eligible for both credits, it may only claim one. It is expected that, given the higher 30% rate, the Clean Technology ITC will be claimed unless there are non-taxable owners. Where projects are owned through partnerships with a mix of taxable and non-taxable partners, it is not clear whether each partner can independently choose which credit to claim.

Other design aspects will be released following consultation with the provincial governments and other relevant parties.

The Clean Electricity ITC would be available as of the day of Budget 2024 for projects that did not begin construction before March 28, 2023, and would be phased out by 2035.

New Clean Technology Manufacturing and Processing ITC

Budget 2023 introduces a refundable ITC for clean technology manufacturing and processing, and critical mineral extraction and processing, equal to 30% of the capital cost of eligible property associated with eligible activities.

Eligible property includes machinery and equipment, including certain industrial vehicles used in manufacturing, processing or mineral extraction. Eligible activities related to clean technology manufacturing and processing include manufacturing of certain renewable energy equipment, nuclear energy equipment, zero-emission vehicles, batteries, upstream components purpose-built to other clean technology manufacturing and processing activities, and the extraction and certain processing activities of six specified minerals (lithium, cobalt, nickel, graphite, copper and rare earth elements).

The ITC would apply to property acquired and available for use on or after January 1, 2024. There would be a gradual phase-out period of this ITC starting with property that becomes available for use in 2032 (20%) that would be reduced to nil after 2034.

Interaction between ITCs

There is a potential for a property to be eligible for more than one of the credits, including, as noted above, the Clean Technology and Clean Electricity ITCs. Budget 2023 addressed the potential for overlap and expressly noted that a business may only claim one of the Clean Technology Manufacturing, Clean Technology, Clean Electricity, Clean Hydrogen or CCUS ITCs where a property qualifies for more than one of these credits.

Update on Pillar One and Pillar Two

Budget 2023 further confirms the federal government's commitment to implement [Pillar One](#) and [Pillar Two](#), which were approved by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting on October 8, 2021. Pillar One contains a new taxing right for market jurisdictions (where customers are located) to be allocated a share of residual profit of a large multinational enterprise. Pillar Two contains model rules designed to assist jurisdictions in introducing, on a uniform and coherent basis, a 15% global minimum tax paid

by large multinational enterprises. Budget 2023 includes an update on recent international developments and implementation steps in relation to Pillar One and Pillar Two.

With respect to Pillar One, Budget 2023 refers to the draft model rules released by the OECD for public comment and states that participating countries are working towards a multilateral convention implementing the Pillar One framework to be signed by mid-2023 with effective dates starting in 2024. However, there is a significant risk that Pillar One will not be adopted as planned. In particular, it is unlikely that Pillar One will proceed without the support of the United States.

Budget 2023 reaffirms the federal government's commitment to implement a unilateral digital services tax (DST) if a multilateral convention implementing the Pillar One framework has not come into force by January 1, 2024. The DST would be payable as of 2024 in respect of revenue earned as of January 1, 2022. Budget 2023 states that revised draft legislation will be released for public comment before the DST is enacted. (An earlier draft was released concurrently with the 2021 Fall Economic Statement.) It is unfortunate that the federal government continues to advocate for the DST to apply retroactively back to January 1, 2022 — particularly when it has yet to release revised draft legislation to implement the tax.

With respect to Pillar Two, Budget 2023 reiterates the federal government's plans to implement Pillar Two. Budget 2023 confirms that Canada will match the EU's intended coming into force dates, with the income inclusion rule (IIR) and domestic minimum top-up tax applying to taxation years beginning on or after December 31, 2023, and the UTPR applying one year later to taxation years beginning on or after December 31, 2024. In particular, Budget 2023 states the government intends to release draft legislative proposals for the IIR and domestic minimum top-up tax for public consultation, with draft legislation for the UTPR to follow. With respect to design, Budget 2023 states that the draft legislative proposals will closely follow the OECD Model Rules, the Commentary on the Model Rules and the administrative guidance agreed to by the Inclusive Framework.

Budget 2023 announces the government's intention to share revenue from Pillar Two with the provinces and territories, including as appropriate, through amendments to the *Federal-Provincial Fiscal Arrangements Act* and associated regulations. Budget 2023 estimates revenue of \$2.8 billion starting in 2025–2026 (booked on a cash basis and taking into account the 18-month delay for the filing of the first GloBE information return) and \$2.4 billion in 2027–2028.

Review of the SR&ED tax incentive program

Budget 2022 announced the government's intention to undertake a review of the existing Scientific Research and Experimental Development (SR&ED) program in the ITA to ensure that it is effective in encouraging research and development in Canada, as well as to explore opportunities to modernize and simplify it. Among other things, Budget 2022 stated that the review would examine whether changes are required to the eligibility criteria of the program and whether tax incentives can play a role in encouraging the development and retention of intellectual property stemming from Canadian research and development, including implementing a so-called "patent box" regime that would typically tax income earned from intellectual property at more favourable rates.

Budget 2023 includes a brief update that the Department of Finance will "continue to engage with stakeholders on the next steps in the coming months."

Personal income tax measures

Employee Ownership Trusts

Budget 2023 proposes to introduce new rules relating to Employee Ownership Trusts (EOTs). An EOT is an arrangement where a trust holds shares of a corporation for the benefit of the corporation's employees. EOTs can be used to facilitate the purchase of a business by its employees, without requiring them to pay directly to acquire shares. The introduction of EOTs is also welcome news to business owners as the ability to effect a "qualifying business transfer" can provide an additional option for succession planning. A qualifying business transfer would occur where a taxpayer disposes of shares of a qualifying business for not more than fair market value to either a trust that qualifies as an EOT immediately after the sale or to a corporation wholly owned by the EOT where the EOT owns a controlling interest in the qualifying business immediately after the transfer.

The new rules would define the qualifying conditions to be an EOT and propose changes to tax rules to facilitate the establishment of EOTs, including (i) extending the capital gains reserve from five years to 10 years for qualifying sales by an individual to an EOT; (ii) creating an exception to the current shareholder loan rule by extending the repayment period from one to 15 years for amounts loaned to the EOT from a qualifying business to purchase shares in a qualifying business; and (iii) exempting EOTs from the 21-year deemed disposition rule that applies to certain trusts.

To qualify as an EOT, a trust would need to meet all of the following conditions:

- The trust must be a Canadian resident trust (excluding deemed resident trusts).
- The trust must hold shares of "qualifying businesses" for the benefit of the employee beneficiaries. A "qualifying business" is a business 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, and it must not carry on its business as a partner to a partnership.
- The interest of each employee beneficiary must be generally treated in a similar manner, other than for distributions, where reasonable, under a distribution formula based on length of service, remuneration and hours worked.
- The beneficiaries must consist exclusively of qualifying employees of the qualifying business and any other qualifying business it controls, with the exclusion of employees who are (or were) significant economic interest holders as well as individuals related to such employees or who have not completed a probationary period of up to 12 months.
- Where a business is sold to the trust, individuals and their related persons who hold a significant economic interest in the existing business prior to the sale cannot account for more than 40% of the trustees of the EOT, the directors of the board of a corporation acting as trustee of the EOT or directors of any qualifying business of the EOT.
- The trust cannot be permitted to distribute any shares of qualifying businesses to its beneficiaries.

The EOT would be a taxable trust and would therefore generally be subject to the same rules

as other personal trusts meaning that undistributed trust income would be taxed in the EOT at the top personal marginal tax rate, whereas trust income distributed from an EOT to its beneficiaries would not be subject to tax at the trust level but at the beneficiary level. Any distribution by the EOT of dividends received from qualifying businesses would retain their character when received by employee beneficiaries and would therefore be eligible for the dividend tax credit.

These amendments would apply as of January 1, 2024.

Alternative Minimum Tax for high-income individuals

The current alternative minimum tax (AMT) is a parallel tax calculation where fewer deductions, exemptions and tax credits are allowed than under the ordinary income tax rules. It currently applies a flat 15% tax rate with a standard \$40,000 exemption amount instead of the usual progressive rate structure. The taxpayer pays the AMT or regular tax, whichever is highest. When the AMT results in additional tax paid, it can generally be carried forward for seven years to be credited against regular tax to the extent regular tax exceeds AMT in those years.

Budget 2023 proposes to better target the AMT to high-income individuals with the following changes in respect of calculation and assessment of the AMT (with additional details to be released later this year):

- Broadening the AMT base:
 - *Capital gains*: the AMT capital gains inclusion rate will be increased from 80% to 100%, while capital loss carryforwards and allowable business investment losses would apply at a 50% rate.
 - *Stock options*: 100% of the benefit associated with employee stock options would be included in the AMT base.
 - *Donations of publicly listed securities*: 30% of capital gains on donations of publicly listed securities will be included in the AMT base. This 30% inclusion would also apply to the full 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.
 - *Deductions and expenses*: 50% of certain deductions and expenses will be disallowed, including interest and carrying charges incurred to earn income from property and non-capital loss carryovers.
- Limiting the application of tax credits:
 - Currently, most non-refundable tax credits can be credited against the AMT. It is proposed that only 50% of such credits be allowed to reduce the AMT subject to certain exceptions.
- Raising the AMT exemption available to individuals (excluding trusts, other than graduated rate estates):

- The government proposes to increase the exemption from \$40,000 to the start of the fourth federal tax bracket (i.e., approximately \$173,000 based on expected indexation for the 2024 taxation year). The exemption amount would be indexed annually to inflation.
- Increasing the AMT rate:
 - The AMT rate will be increased from 15% to 20.5%, corresponding to the rates applicable to the first and second federal income tax brackets, respectively.

Trusts that are currently exempt from the AMT would remain exempt, although the government indicates it will continue to examine whether additional types of trusts should be exempt from the AMT.

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

Retirement compensation arrangements

Retirement compensation arrangements (RCAs) are employer-sponsored arrangements that generally allow an employer to provide supplemental pension benefits to employees.

Employers can choose to pre-fund supplemental retirement benefits through contributions to a trust established under an RCA (RCA trust) where contributions to the RCA trust are subject to a refundable tax imposed at a rate of 50%. The tax is generally refunded as the retirement benefits are paid from the RCA trust to the employee.

Employers who do not pre-fund supplemental retirement benefits through contributions to an RCA trust and instead settle retirement benefit obligations as they become due, can obtain a letter of credit (or a surety bond) issued by a financial institution in order to provide security to their employees. The payment of the annual fee or premium charged by the issuer is subject to the 50% refundable tax. In this case, when retirement benefits become due from the unfunded plan, the employer pays the benefits out of corporate revenues. This payment does not trigger a 50% refund. Employers are therefore 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 (or a surety bond) 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.

It also proposes to allow employers to request a refund of previously remitted refundable taxes in respect of fees or premiums paid 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. Employers would be eligible for a refund of 50% of the retirement benefits paid, up to the amount of refundable tax previously paid. This change would apply to retirement benefits paid after 2023.

Intergenerational business transfer framework & Bill C-208 follow-up

Section 84.1 of the ITA is an anti-“surplus stripping” rule that prevents a taxpayer from implementing transactions that effectively convert dividends to capital gains to enjoy a more favourable tax treatment. Bill C-208 is a private member's bill that was introduced to facilitate

intergenerational business transfers by introducing exceptions to the application of the rule in section 84.1 to certain share transfers.

Budget 2023 states that the rules introduced by Bill C-208 did not contain sufficient safeguards to ensure that section 84.1 would not apply only when a genuine intergenerational business transfer actually takes place. The proposed amendments provide for two transfer options:

- an immediate intergenerational business transfer (three-year test) based on arm's length sale terms
- a gradual intergenerational business transfer (five-to-10-year test) based on traditional estate freeze characteristics

Bill C-208 provided two conditions to when the transfer of a share can be excluded from the application of section 84.1: (a) the share must be a "qualified small business corporation share" or a "share of the capital stock of a family farm or fishing corporation" at the time of transfer; and (b) the purchaser corporation of the share must be controlled by one or more persons each of whom is an adult Child of the transferor (Child meaning for these purposes a child, grandchild, step-child, child-in-law, niece and nephew, and grandniece and grandnephew).

Budget 2023 proposes to add five additional conditions. The requirements of these proposed conditions vary, mostly with respect to timing, depending on whether the transfer is an immediate business transfer or a gradual business transfer. The five new conditions are

- transfer of control of the business (requires the transferor to transfer control within a certain timeframe)
- transfer of economic interests in the business (requires the transferor to transfer the common growth shares within a certain timeframe and to reduce the economic value of their debt and equity interests in the business to a certain threshold)
- transfer of management of the business (requires transferor to transfer the management of the business within a reasonable time)
- child retains control of the business (requires the child to retain legal [not factual] control of the business for a certain period of time following the share transfer)
- child works in the business (requires the child to remain actively involved in the business for a certain period of time following the share transfer)

Under the proposed amendments, the transferor and transferee are required to jointly elect for the transfer to qualify as either an immediate business transfer or gradual business transfer. Budget 2023 proposes that the child would be jointly and severally liable for any additional taxes payable by the transferor, because of section 84.1 applying, in respect of a transfer that does not meet the applicable conditions and to extend the limitation period for reassessing the liability that may arise on the transfer by three years for an immediate business transfer and by 10 years for a gradual transfer.

Additionally, Budget 2023 proposes a 10-year capital gains reserve for intergenerational share transfers that satisfy the conditions in the proposed amendments. The proposed amendments also replace certain rules in Bill C-208 relating to the lifetime capital gains

exemption with relieving rules that apply upon a subsequent arm's length share transfer or upon death of a child.

The proposed changes would apply to dispositions of shares that occur on or after January 1, 2024.

Other personal income tax measures

Budget 2023 proposes or confirms various other personal income tax measures. These measures include a new "Grocery Rebate" in the form of an increase to the maximum Goods and Services Tax Credit available for January 2023 to low- and modest-income individuals and families. Budget 2023 also confirms the government's intention to introduce the Tax-Free First Home Savings Account, previously announced in Budget 2022, which is proposed to be available as of April 1, 2023, to permit up to \$40,000 of tax-deductible contributions and the tax-free withdrawal of funds (including of earned investment income) to make qualifying first home purchases.

Sales and excise tax measures

GST/HST on payment card clearing services

Budget 2023 proposes to amend the *Excise Tax Act* (ETA) to impose GST/HST on services provided by payment card network operators. In particular, certain services provided by payment card network operators in respect of the authorization of transactions, clearing and settlement (or services provided in conjunction with such services) would be excluded from being non-taxable financial services. Budget 2023 states that the intent of these changes is to "clarify" the law following "a recent court decision [that] found that the GST/HST does not apply to supplies of these services", as "it has always been widely understood that the services of payment card network operators are excluded from the GST/HST definition of 'financial service'". It is not clear where this "wide understanding" came from as most taxpayers and practitioners, as well as the Federal Court of Appeal, have consistently taken the opposite view.

The proposed amendment applies both prospectively and will also generally apply retroactively — for instance, where the supplier charged, collected or remitted tax or where the recipient would have been required to self-assess under Division IV of the ETA.

Even worse than the fact that the Department of Finance has created retroactive legislation and tax obligations where none had previously existed according to the courts, Budget 2023 extends the limitation period for assessments relating to these provisions to the later of the limitation period that otherwise applies for purposes of GST/HST and one year after the proposed amendment receives royal assent. It is not clear why a decision of the Federal Court of Appeal in 2021 should cause the Department of Finance to open up reporting periods that are more than four years old, many of which were already statute-barred at the time the decision was released. Not surprisingly, the Department of Finance did not extend the period for payment card network operators to claim input tax credits in relation to these supplies.

Change to 'credit union' definition

Budget 2023 proposes to eliminate the revenue test (measuring whether an entity earns more than 10% of its revenue from sources other than specified sources) from the "credit

union” definition in the ITA which is used for both ITA and GST/HST purposes. The change is described as accommodating how credit unions operate (mostly as full-service financial institutions with a suite of financial products and services) and avoiding unforeseen income tax and GST/HST consequences if the revenue test remained. The amendment would apply in respect of taxation years ending after 2016.

Other measures

Confirmation of intention to proceed

Budget 2023 reaffirms the federal government’s intention to proceed with numerous previously announced tax measures, including

- legislative proposals released on November 3, 2022, with respect to Excessive Interest and Financing Expenses Limitations 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 the Investment Tax Credit for Clean Technologies
- legislative proposals released on August 9, 2022, including with respect to the following measures:
 - borrowing by defined benefit pension plans
 - 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
 - other technical amendments to the *Income Tax Act* and *Income Tax Regulations* proposed in the August 9 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 GST/HST 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

- measures confirmed in [Budget 2016](#) relating to the GST/HST joint venture election
- other technical amendments as required to improve the certainty and integrity of the tax system

If you have any questions or require additional analysis on Budget 2023, please contact any member of our [National Tax Department](#). We invite you to [register for our seminar](#) on Tuesday, April 4 for further analysis of Budget 2023.

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