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Canadian federal government releases significant draft tax legislation package

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On August 4, 2023, the Canadian federal government released a package of draft legislation to implement various tax measures, update certain previously released draft legislation, and make certain technical changes (Draft Legislation). The Draft Legislation includes measures first announced in the 2023 Federal Budget, as well as updated versions of draft legislation released in Budget 2023 or earlier. The news release that accompanied the Draft Legislation invites Canadians to make submissions with respect to the Draft Legislation (other than the global minimum tax) by September 8, 2023.

The Draft Legislation covers a wide variety of measures. The global minimum tax, revised EIFEL rules, and green initiatives will be addressed in separate Updates. Certain other measures are not included in the Draft Legislation (such as changes to the rollover under subsection 85.1(3) applicable to certain transfers of foreign affiliate shares or changes to the withholding tax rules applicable to payments made by partnerships). We anticipate that the Department of Finance will consider the comments on those rules made by Osler and others before introducing any further amendments.

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Revised GAAR amendments

Budget 2023 introduced draft amendments to the General Anti-Avoidance Rule (GAAR). Although the Draft Legislation makes a number of key changes to the prior draft amendments, those changes generally do not address the concerns that were expressed about the draft amendments in submissions made by Osler and others. The August 4 release confirms that the amended GAAR will apply for transactions that occur on or after January 1, 2024.

Preamble

Budget 2023 proposed to add an introductory provision to the GAAR. The Explanatory Notes released on August 4, 2023 explain that this "preamble" is not part of the GAAR analytical framework, but is intended to emphasize "key considerations" relating to the GAAR's purpose and operation.

The wording of the preamble remains largely unchanged from that proposed in Budget 2023, with the notable exception that the statement that the GAAR can apply "regardless of whether a tax strategy is foreseen" has been removed. The Explanatory Notes state that this change was made because the Supreme Court of Canada's decision in *Dean's Knight* clarified and confirmed that the GAAR is not limited to unforeseen situations.

Economic substance rule for misuse and abuse

The revised draft amendments create a "presumption", such that where an avoidance transaction significantly lacks economic substance, the transaction is presumed to result in a misuse or abuse. This is a change from the draft amendments in Budget 2023, which provided that such transactions "tend to indicate" misuse or abuse.

The Explanatory Notes make clear that the presumption is rebuttable. Therefore, even where an avoidance transaction significantly lacks economic substance, the GAAR will not apply if the taxpayer can show the absence of misuse or abuse. The Explanatory Notes provide that an example of when the taxpayer can rebut the presumption is where the rationale underlying a provision is to encourage particular activities, and the taxpayer demonstrates that the effect of the transaction was what Parliament intended to encourage. Two examples provided in the Explanatory Notes are transferring funds to a TFSA and certain loss utilization transactions within a related group.

The Draft Legislation provides three factors that establish a transaction is significantly lacking in economic substance. The Explanatory Notes state that a determination of whether a transaction is significantly lacking in economic substance is "binary" and that the factors create a "fairly high standard for the test to be met". If it is determined that the transaction is significantly lacking in economic substance, then the presumption applies; in other cases, the "standard" misuse or abuse analysis applies.

The first factor in determining if the transaction is significantly lacking in economic substance is whether all or substantially all the opportunity for gain or profit and risk of loss of the taxpayer (together with non-arm's length taxpayers) remained unchanged. However, the Explanatory Notes caution that this factor may be less relevant when applied to genuine commercial transactions between family members, such as one sibling selling a portion of their business to another sibling on arm's length terms.

The Explanatory Notes provide two examples of circumstances where the first factor may be relevant:

1. Shifting rights or assets from one subsidiary to another within a group in circumstances where the economic position of the group has not changed, and

2. Transactions between shareholders and corporations that they control. For example, where an individual owns a Canadian corporation which has retained earnings and, instead of paying out those earnings as a dividend, undertakes a series of transactions to receive the distribution as a capital gain.

Budget 2023 had listed three techniques to assess transactions where the taxpayer's opportunity for gain or profit and risk of losses would be unchanged: a circular flow of funds, offsetting financial positions, and timing between steps in a series. The revised draft amendments add "the use of an accommodation party" to this list.

Under the revised draft amendments, no changes have been made to the second and third factors in determining if a transaction is significantly lacking in economic substance, namely, (1) whether it is reasonable to conclude that, at the time the transaction or series was entered, the expected value of the tax benefit exceeded the expected non-tax economic return (excluding tax advantages connected to another jurisdiction), and (2) whether 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.

Adding a penalty

Budget 2023 proposed to introduce a penalty where the GAAR was found to apply equal to 25% of the tax benefit. This penalty has been revised to the formula: (A – B) x 25% – C. Where:

- A is the tax payable by the person for the year.
- B is the tax that would have applied if the GAAR did not apply, and
- C is the amount of penalty payable under subsection 163(2) (known as gross negligence penalty).

The Explanatory Notes state that, where the "tax benefit" is the creation of a tax attribute that has not yet reduced tax, no penalty will apply until the year in which the tax attribute is used to reduce tax payable (absent the application of the GAAR). Where an unutilized tax attribute is successfully challenged under the GAAR, no penalty would apply (since the formula will result in a nil penalty).

An exception to the penalty was introduced in the revised draft amendments where, at the time of the transaction, it was reasonable to conclude that the GAAR would not apply because the transaction was "identical or almost identical" to a transaction that was the subject of: (1) administrative guidance or statements by the Minister, or (2) one or more court decisions. The Explanatory Notes state that this exception assures the penalty will not apply to a taxpayer who reasonably relied on the current state of case law and administrative guidance in entering into a transaction. Since the test is applied at the time the transaction is entered into, this exception could be relied upon even where there are subsequent changes in administrative position or jurisprudence. However, the Explanatory Notes caution that the "identical or almost identical" threshold is high, and a transaction that is "merely similar" would not qualify.

In addition, the penalty will not apply where the taxpayer made a voluntary disclosure of the transaction under the reportable transaction rules in section 237.3. The revised draft amendments provide that the time limit to make the voluntary disclosure is "on or before the taxpayer's filing-due date for the taxation year in which the transaction occurs." The revised draft amendments also permit late filing the voluntary disclosure up to one year after the taxpayer's filing-due date.

Share buyback tax

Draft legislation to implement a 2% tax on the annual net value of share repurchases by public corporations was first released in Budget 2023. This measure was 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 revised Draft Legislation includes certain technical changes to the prior draft, including a modest expansion of the exceptions for debt-like instruments and for corporate reorganization and acquisition transactions.

The measure would apply to Canadian-resident corporations with shares listed on a designated stock exchange at any time in a taxation year (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) trusts and SIFT partnerships. In addition, the measure applies to publicly traded entities that would be SIFT trusts or SIFT partnerships if their assets were located in Canada.

The tax is equal to 2% of the difference between the total fair market value of equity redeemed, acquired or cancelled by an entity in the year, 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.

Compared to the prior draft, the revised Draft Legislation expands the exception for share cancellations on a "reorganization or acquisition transaction" to allow additional forms of corporate reorganizations to occur without triggering the share buyback tax, such as spin-offs of Canadian-resident entities under section 86 and triangular amalgamations. The definition also has been revised to expand the scope of certain equity issuances, the fair value of which reduce the share buyback tax, to include equity issued on the conversion of convertible debt instruments that were issued solely for cash consideration.

The scope of "substantive debt" (debt-like instruments, the issuance and cancellation of which do not affect the calculation of the buyback tax) also has been expanded to include, among other things, certain instruments with a variable rate of distribution determined by reference to a market rate of interest (in addition to fixed-rate instruments), certain non-viability contingent capital instruments, and certain securities that entitle holders to an early redemption premium.

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 "subsidiary" affiliates to have been a repurchase by the entity itself (with exceptions for ordinary course acquisitions by registered securities dealers, certain equity-based compensation arrangements, and acquisitions by trusts governed by employee profit-sharing plans or deferred profit-sharing plans) and anti-avoidance rules that address certain transactions undertaken to avoid payment of the tax.

The tax applies in respect of net repurchases of equity on or after January 1, 2024. Entities that redeem, acquire or cancel equity after that date will be required to file an annual return in prescribed form and pay any amount of share buyback tax owing on or before its balance-due day for the year.

Employee ownership trusts

The federal government introduced employee ownership trusts (EOTs) in Budget 2022 and followed up with draft legislation in Budget 2023. The Draft Legislation is largely in line with that released in Budget 2023, with only minor technical differences. As outlined in the Osler Federal budget briefing 2023, 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 succession planning, without requiring the employees to pay directly to acquire shares.

As announced in Budget 2023, these amendments will apply as of January 1, 2024.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) is a separate tax calculation that allows fewer deductions, exemptions, and tax credits than are available under regular income tax rules. Currently, it has a flat 15% tax rate with a standard $40,000 exemption instead of the ordinary progressive rate structure. Taxpayers must pay either the AMT or the ordinary income tax, whichever is higher.

The Draft Legislation implements various changes announced in Budget 2023 that will increase the amount of AMT payable by individuals and trusts and the frequency with which AMT will apply.

Changes to 'Minimum Amount' formula

If an individual's or trust's "minimum amount" exceeds their tax otherwise payable under the *Income Tax Act* (ITA), they are liable for AMT (unless they are specifically exempted from AMT). The Draft Legislation changes certain variables/inputs in the minimum amount calculation.

A key variable in computing the minimum amount is the AMT rate, which currently is the same rate that applies to the first federal income tax bracket (15%). The Draft Legislation increases this to 20.5%, which is the rate applicable to the second bracket.

The AMT exemption will increase from the current allowable deduction of $40,000 to the start of the fourth federal tax bracket, which is estimated to be around $173,000 for the 2024 taxation year.

The minimum amount is currently reduced by the full amount of the taxpayer's "basic minimum tax credit" (an amount computed under the AMT rules) for the year. Under the Draft Legislation, only one-half of the basic minimum tax credit will reduce the minimum amount.

Changes to adjusted taxable income

The quantum of an individual's or trust's "adjusted taxable income" (ATI) is a key determinant of whether the individual or trust will be subject to AMT, since very roughly speaking (leaving out the exemption and basic minimum tax credit variables), a taxpayer's "minimum amount" is equal to the product of ATI – which is effectively the tax base for AMT – and 20.5%. The Draft Legislation includes several changes to broaden ATI by further limiting certain tax items, such as exemptions, deductions and credits.

Under current law, in computing an individual's ATI, taxable capital gains, allowable capital losses, allowable business investment losses (ABILs) and gains from listed personal property are included at a rate of 80%. The Draft Legislation will change the inclusion rate to 100% for capital gains, allowable capital losses and gains from listed personal property. Coordinating changes are made to the manner of computing the ATI of a trust when it designates distributed amounts as paid out of capital gains, and the ATI of trust beneficiaries who are allocated such capital gains, to reflect the change from an 80% to a 100% inclusion rate for capital gains.

The Draft Legislation further modifies the ATI computation by eliminating the exemption for gifts to qualified donees, resulting in capital gains on such gifts being subject to the new 100% inclusion rate. However, an exception is made for gifts of publicly listed securities, which would be subject to a 30% inclusion rate.

The Draft Legislation will apply the same 30% inclusion rate to the amount of a benefit associated with employee stock options on underlying securities that are publicly listed and have been donated.

The 50% stock option deduction under paragraph 110(1)(d) no longer will be available in computing ATI, so the inclusion rate for stock option benefits otherwise eligible for a paragraph 110(1)(d) deduction is now 100%. Other deductions for stock options provided under paragraphs 110(1)(d.1) to (d.3) also will be removed.

Under the Draft Legislation, ATI as the AMT tax base is further expanded by disallowing 50% of interest and financing expenses in respect of borrowing to earn income from property (such as rent, dividends or interest).

The Draft Legislation also disallows 50% of some other deductions, including deductions in respect of: old age pension supplement, workers compensation, certain office and employment expenses, Canada Pension Plan/Quebec Pension Plan contributions on self-employment earnings, moving expenses and child care expenses.

Loss carryforwards and carrybacks

Under current law, the amount of non-capital loss from other years that can be deducted in computing ATI is the lesser of (a) the amount deducted for the year under the normal income tax rules, and (b) the amount of loss from such other years computed using the various ATI modifications in the AMT rules. The Draft Legislation changes this by providing for a deduction of only 50% of the amount deducted for the year under normal income tax rules on account of carryforwards and carrybacks of non-capital loss. The same 50% rate is applied to carryforwards of a partner's "limited partnership loss" (within the meaning of the "at-risk" rules applicable to limited partners under the ITA).

The inclusion rate for capital loss carryforwards is reduced to 50% from the current 80%.

Exempt trusts

The Draft Legislation adds to the list of trusts that are exempted from AMT certain additional types of trusts. Three of the new exemptions are relevant to trusts used for commercial purposes, including those used as collective investment vehicles:

- A trust, all of the units of which are traded on a designated stock exchange.
- A trust, some of the classes of the units of which are traded on a designated stock

exchange, and where appropriate trust information reporting is done in respect of the unlisted units, and

- A trust that satisfies all the conditions to be an “investment fund” as defined under the trust loss restriction event rules, including following a reasonable policy of investment diversification and limiting its undertaking to investing its funds in property.

The new categories provide welcome relief from AMT exposure for ETFs, pooled funds and mutual funds that are not sufficiently widely held to qualify as mutual fund trusts.

The Draft Legislation also clarifies that a number of trusts exempt from Part I tax are exempt from AMT, and also provide that a “taxable” trust (i.e., a trust that is not statutorily exempt from Part I tax) is exempt from AMT if it meets four conditions:

1. All of the beneficiaries of the trust are exempt from AMT or are trusts, all of the beneficiaries of which are exempt from AMT.
2. No beneficiary other than one described in clause (i) can be added.
3. All of the beneficial interests in the trust are “fixed interests” (as defined in the non-resident trust rules in the ITA), and
4. The trust is irrevocable.

It is not entirely clear how the last two conditions are meant to interact. One of the requirements of a fixed interest is that no amount of the capital of the trust to be distributed can depend upon the exercise of a discretionary power, other than where the power is consistent with normal commercial practice. It is normal commercial practice that a unitholder in a trust can receive back trust capital by requesting a redemption. Redemptions may, in some cases, occur at the instance (in the discretion of) the trustee. Presumably, the fact that a normal commercial trust, such as a trust that satisfies paragraph 108(2)(b) of the ITA, is redeemable on demand would not disqualify the trust from being considered to be “irrevocable” (condition (iv)). An irrevocable trust is one that cannot be revoked by the settlor without the consent of the beneficiaries or a court order. It is unclear how to apply this concept to standard redemption terms of unit trusts, particularly where the settlor and beneficiary are the same entity (i.e., an investor that has purchased units for consideration).

Other trusts that are explicitly carved out from the application of AMT include trusts governed under a registered pension plan, pooled registered pension plan, deferred profit-sharing plan, registered education savings plan, registered retirement income fund, registered retirement savings plan, tax-free savings account, employee profit sharing plan, registered supplementary unemployment benefit plan, or first home savings account.

Mutual fund trusts, segregated fund trusts and other trusts that are currently exempt from AMT would continue to be exempt.

Effective date

The proposed changes to the AMT rules come into effect for taxation years beginning after December 31, 2023.

Retirement compensation arrangements – letters of credit

The Draft Legislation contains detailed provisions implementing two measures that apply to employers who, choosing not to pre-fund supplemental retirement benefits through contributions to a retirement compensation arrangement (RCA) trust, instead settle retirement benefit obligations as they arise, and opt to use a letter of credit or surety bond from a financial institution to provide security to their employees. The employer pays an annual fee or premium to secure or renew the letter of credit or surety bond (an LC fee). Under the ITA, the payment of an LC fee in such circumstances is treated as a contribution to an RCA and thus subject to a 50% refundable tax. However, since there are no benefit payments from an unfunded plan to trigger a refund, employers are required to fund increasing refundable tax balances without a practical means of recovery. The Draft Legislation provides relief for LC fees paid both before and after March 28, 2023.

For LC fees paid on or after March 28, 2023, Budget 2023 had proposed to exempt from RCA refundable tax LC fees paid in respect of an RCA that supplements a registered pension plan (RPP). The Draft Legislation expands the scope of this measure to apply to any RCA that is a “specified arrangement”, which means an RCA that either: (a) provides benefits that supplement the benefits provided under one or more of a RPP, a pooled registered pension plan, a registered retirement savings plan or a deferred profit sharing plan, or (b) meets all or substantially all of the conditions to be/remain registered as a RPP except for the pension adjustment limits in the ITA, and the maximum benefit limits in the income tax regulations. If LC fees are paid under a specified arrangement, they will be classified as “excluded contributions”, which the Draft Legislation exempts from the application of the 50% refundable tax on contributions to RCAs.

The provision regarding the non-inclusion of “excluded contributions” in refundable tax would be applicable to LC fees that have been paid on or after March 28, 2023.

The Draft Legislation also implements a second measure from Budget 2023, which provides relief for taxpayers that paid refundable tax with respect to excluded contributions made prior to March 28, 2023. The Draft Legislation creates a mechanism for obtaining a refund of such contributions generally at a rate of 50% of the retirement benefits paid after 2023 by an “eligible employer”. For this purpose, an eligible employer is an employer who paid an excluded contribution under a specified arrangement before March 28, 2023. Provided that the eligible employer makes a refund election for a particular year and certain other specified conditions are met, the employer (or RCA custodian) can obtain a refund of up to 50% of all retirement benefits the employer paid in the year for the benefit of RCA beneficiaries whose retirement benefits were secured under a specified arrangement with a letter of credit or surety bond. The refund amount claimed in a year cannot exceed the “specified refundable tax” balance of the specified arrangement at the end of the taxation year. The specified refundable tax is equal to the positive difference between (A) the total amount of refundable tax that was paid solely with respect to LC fees incurred prior to March 28, 2023 for the purposes of securing future retirement benefit payments under an RCA (this amount does not change year to year), and (B) the total amount of all refunds payable for each preceding year (this amount increases each year as refunds are paid).

Intergenerational business transfers

Budget 2023 stated that the rules introduced by Bill C-208, which were intended to facilitate intergenerational business transfers, did not contain sufficient safeguards to ensure that section 84.1 would only apply when a genuine intergenerational business transfer takes place. Budget 2023 proposed two transfer options:

- An immediate intergenerational business transfer (three-year test) based on arm’s length sale terms.
- A gradual intergeneration business transfer (five-to-10-year test) based on traditional estate freeze characteristics

Budget 2023 also proposed five additional conditions to safeguard the transfer process. The Draft Legislation is largely in line with Budget 2023, with additional interpretive rules to further bolster the conditions required to qualify for the transfer options:

- For purposes of the transfer of control requirement, a new interpretive rule to exclude transfers among spouses.
- For transfers of partnerships, a new interpretive rule to help determine whether a taxpayer controls a partnership.
- To determine a taxpayer's ownership, a new interpretive rule that defines direct or indirect ownership in respect of property.
- A new definition of the word "management", which would refer to the direction or supervision of business activities, but would exclude the provision of advice.

In addition to these new interpretive rules, the Draft Legislation also provides two new relieving rules:

- Where an intergenerational business transfer takes place pursuant to one of the two transfer options, and the child or children subsequently dispose of their shares to another child or group of children, a new rule ensures that the conditions to the intergenerational transfer are still met.
- Where the transferred business has ceased to be carried on because all of the assets were disposed to satisfy debts owed to creditors, a new rule relieves against the requirement that the transferred business be carried on for a minimum period of time.

As announced in Budget 2023, these amendments will apply to dispositions of share that occur on or after January 1, 2024.

GST/HST

Extended limitation period for section 218.01

The Draft Legislation proposes to amend subsection 298(1) of the *Excise Tax Act* (ETA) to extend the assessment period from four years to seven years for assessments of net tax that are "made solely to take into account an amount of tax payable under section 218.01". Section 218.01 is specific to financial institutions and requires them to self-assess on certain outlays made or expenses incurred outside of Canada which would otherwise not normally be taxable. This change will affect selected listed financial institutions for any assessment of their net tax made under subsection 225.2(2) of the ETA (adjustments under the special attribution method) that relate to self-assessments of GST under section 218.01. This is a technical change that aligns the limitation period for an assessment of net tax taking into account an amount payable under section 218.01, with the limitation period for an assessment of tax payable by the financial institution under section 218.01.

Prescribed services for paragraph (r.6) of the 'financial service' definition

The Draft Legislation also includes regulations setting out the various "prescribed services" that are excluded from new paragraph (r.6) of the definition of "financial service". For context, legislation announced in Budget 2023 retroactively changed the law with respect to the treatment of payment card processing services. That amendment reversed the decision of the Federal Court of Appeal in *CIBC v The Queen* that had upheld the longstanding approach of taxpayers. New paragraph (r.6) sets out the services that will now be subject to GST.

Agency elections added to amalgamation and windings-up continuation regulation

The Draft Legislation extends the amalgamation and windings-up continuation regulations to include agency elections made under subsections 177(1.1) and (1.11). The agency elections generally allow an agent to account for tax in respect of a supply made by its principal. The addition of these provisions to the regulations would allow such elections to survive an amalgamation or winding up in certain circumstances.

Changes to percentage for participating province for selected listed financial institutions

Under the special attribution method in subsection 225.2(2) of the ETA, the net tax of a selected listed financial institution (SLFI) for a participating province (i.e. a province that has signed onto the HST) is adjusted pursuant to a formula intended to reflect where its operations, investors, depositors, members or insured risks (as the case may be) are located. One of the elements of this formula is the SLFI's "percentage for the participating province". The Draft Legislation includes some changes to how certain SLFIs (such as insurers) calculate their percentages for participating provinces. For example, the denominator for insurance companies has been expanded from risk relating to property or persons in Canada to risk relating to property and insurance that were included in computing income under Part I of the ITA. This should result in a lower percentage attributable to participating provinces.

Excise duties on vaping products

The Draft Legislation makes changes to the rules for excise duties on vaping products under the *Excise Act, 2001*. These changes are generally favourable and appear to address certain likely unintended results from the prior legislation.

In particular, the Draft Legislation would allow vaping product licensees to import unstamped products for stamping in Canada. The changes would also slightly expand the class of prescribed persons who may possess vaping excise stamps.

Finally, the Draft Legislation would add certain new penalties for contravention of the rules for excise duties on vaping products.

Select Luxury Items Tax Regulations

The Draft Legislation proposes regulations that expand on the *Select Luxury Items Tax Regulations* previously proposed in August 2022 and, in particular, would:

- Exclude aircraft or vessels from being subject aircraft or vessels in certain circumstances.
- Provide new rules addressing transfers of partial ownership of a subject item, and the determination of the taxable amount on such a transfer:
- Prescribe circumstances under which an exemption certificate would apply, or the tax would otherwise not be payable, on the sale of a subject aircraft for export, and

- Provide some transitional relief in respect of agreements entered into before 2022.

If you have any questions or require additional analysis on the Draft Legislation, please contact any member of our National Tax Department.