Federal tax rate increases for Canadians

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On December 7, 2015, Canada's new Finance Minister, Bill Morneau, tabled measures to reduce the federal individual income tax rate for the $45,282 to $90,563 tax bracket from 22% to 20.5%, and introduced a new 33% top rate bracket for taxable income over $200,000, effective Jan. 1, 2016. Additionally, the Tax-Free Savings Account (TFSA) annual contribution limit will be rolled back to $5,500 after 2015. While these amendments were not unexpected as they were part of the Liberal's election platform, the proposal also includes subtle but important consequential amendments affecting tax rates/credits for trusts and estates, "kiddie tax", charitable donations, corporate refundable taxes on investment income for Canadian-controlled private corporations (CCPCs), and Part IV tax. This short blog summarizes these changes and offers some thoughts.

Below is a short summary of the changes, all of which become effective January 1, 2016:

1. Federal personal tax rate for taxable income between $45,282 and $90,563 will be reduced from 22% to 20.5%;
2. The top federal personal tax rate of 29% will apply to taxable income between $140,388 to $200,000, and a new top federal personal tax rate of 33% will apply to taxable income greater than $200,000;
3. The rate for the federal charitable donation tax credit in excess of $200 will be increased from 29% to 33%, but only to the extent the individual's taxable income exceeds $200,000;
4. The rate of tax on "split income", which generally comprises of dividends from unlisted shares, certain business/partnership/trust income allocated to a minor from a related party and certain capital gains earned by a minor, also known as "kiddie tax", will be increased from 29% to 33%;
5. The flat tax rate applicable to trusts and estates, other than a graduated rate estate (GRE) or a qualified disability trust (QDT), will be increased from 29% to 33%;
6. Consequential rate changes to the taxation of investment income of private corporations, effective Jan. 1, 2016, and pro-rated for taxation years that straddle Jan. 1, 2016:
    a. The rate of refundable tax for a CCPC's investment income will be increased from 6.67% to 10.67%
    b. The addition to refundable dividend tax on hand (RDTOH) for investment income earned by a CCPC will be increased from 26.67% to 30.67%;
    c. The rate of refundable Part IV tax on portfolio dividends earned by a private corporation will be increased from 33.33% to 38.33%;
    d. The rate at which refunds are made out of a private corporation's RDTOH will be increased from 33.33% to 38.33%.
7. The previous government enacted an increase of the TFSA contribution limit from $5,500 to $10,000 for 2015 and subsequent years. The proposed measure announced on Dec. 7 will reverse this increase after 2015, so that for 2016, an individual's TFSA annual contribution limit will be $5,500. This limit will be indexed to inflation for years subsequent to 2016.

A previous blog from our firm has already discussed the politics of the Liberal rate increases, so we will not venture into it again here. But it is nevertheless interesting to point out that, by the government's own calculation, the net impact of these changes will cost the federal government $1.27 billion in 2016 and by the end of 2021, $6.59 billion.

Given there are less than four weeks before the end of 2015, business owners across the country are thinking about year-end planning. In Alberta, the double-dose of provincial and federal tax rate increases has added particular urgency to 2015 year-end planning. Consider the following rate increases for an Albertan earning various types of income at the top marginal tax bracket (over $300,000 of taxable income):

Type of income	2015 tax rates	2016 tax rates
Ordinary income	40.25%	48.00%
Capital gains	20.13%	24.00%
Non-eligible dividends	30.84%	40.24%
Eligible dividends	21.02%	31.71%

These tax rate increases are particularly pronounced for dividends, with the increase for eligible dividends representing a whopping 50% increase (from 21.02% to 31.71%). In some circumstances, it may be worthwhile to consider accelerating dividend income into 2015 to capture the lower tax rates. However, if inter-corporate dividend planning is involved, one must consider the recently proposed amendments to subsection 55(2) which has completely changed the landscape on inter-corporate planning (see our recent blog on this topic). A keen observer will also notice that starting in 2016, the top rate on capital gains will be significantly less than the effective tax rates of both non-eligible and eligible dividends – a new phenomenon in Alberta where the effective tax rate on eligible dividends has traditionally been on-par with capital gains. This shift means that planning that converts dividend income into capital gains has suddenly become much more interesting in Alberta. This includes planning for a taxpayer's death: for post-mortem planning after 2015, on a pure tax rate basis, a "pipeline" strategy is preferable so as to obtain capital gains rates of 24% as opposed to a subsection 164(6) strategy, which will result in taxable dividend rates of 31.71% or 40.24%. Of course, considerations other than tax rates will need to be taken into account when implementing a post-mortem plan.

Practitioners should also be mindful of the "kiddie tax" rate increase and the increase for all trusts and estates (other than a GRE or a QDT) effective Jan. 1, 2016, and this 33% rate will be a flat rate regardless of income level. This timing coincides with the coming-into-force of the GRE regime, which takes away all preferential treatment previously afforded to testamentary trusts and limits them only to GREs post 2015.

These personal tax rate increases, plus the increase in Alberta corporate tax rates, also means that it is going to become more punishing for incorporated workers who are personal services businesses (PSB) under the Income Tax Act. In addition to denial of substantially all expense deductions, the total tax burden of a PSB structure in Alberta, at top marginal rates, will be an astonishing 59% in 2016 (compared to 52% in 2015) on a fully-distributed basis. As explained in our previous blog, there are many incorporated workers in the oil and gas industry in Alberta who may be caught inadvertently under these PSB rules.

A silver lining to the new 33% top tax bracket is the corresponding increase to the charitable donation tax credit for those individuals whose income are subject to this new bracket. Combined with the generous Alberta donation tax credit of 21%, starting in 2016, an Albertan at the top rate bracket will be able to recover 54 cents on every dollar donated to a registered charity in excess of $200.

Based on these proposed tax rates, the estimated total tax burden and potential deferral opportunity on various forms of income earned by a CCPC, once it is flowed all the way through to a shareholder as a dividend at the top federal and Alberta marginal rates are as follows:

	General Rate Business Income			Small Business Income			Investment Income		
	2015	2016	2017	2015	2016	2017	2015	2016	2017
Combined Corporate and Personal Taxes	41.6%	50.2%	50.2%	40.5%	48.3%	48.5%	44.0%	52.2%	52.6%
Net benefit (cost) of incorporation	-1.3%	-2.2%	-2.2%	-0.3%	-0.3%	-0.5%	-3.7%	-4.2%	-4.6%
Deferral (prepayment) if retained in the CCPC	15.6%	23.2%	23.2%	26.5%	34.8%	35.5%	-1.7%	1.5%	2.0%

As you can see, there is close to perfect integration in Alberta for corporate income entitled to the small business deduction, because the net cost of earning the income corporately compared to earning the same personally is generally less than 0.5%. Due to the increases in personal tax rates, the deferral opportunity will become a lot more significant starting in 2016 for corporate-earned business income (34.8% deferral opportunity for corporate income entitled to the small business deduction, and 23.2% for general rate business income). Therefore, to the extent the corporation's shareholders do not require distribution and their marginal rates are already utilized, consideration should be given to retaining such corporate profits to maximize the tax deferral advantage.

Corporate-earned investment income, however, will become less attractive. In 2015, the net tax disadvantage of earning investment income in a CCPC compared to earning it personally is 3.7%. This disadvantage increases to 4.6% in 2017. However, certain planning can be done to avoid this (e.g. there are ways to convert a CCPC to a non-CCPC in order to avoid the refundable tax regime and to gain access to eligible dividends). The proposed increases to a CCPC's refundable tax on investment income and to Part IV tax have no net impact on flow-through tax rates because all such additional taxes are refundable through the RDTOH regime. The intention behind the increases to corporate refundable taxes is to match the increases in personal tax rates, in order to prevent a deferral opportunity on corporate-earned investment income. However, what is interesting is that even with these increases, starting in 2016, there is generally no longer a net tax benefit to paying out non-eligible dividend to recover RDTOH if the shareholder is already at top marginal tax rates. In 2016, the corporate tax on investment income is actually 1.5% lower than the net combined personal and corporate tax after the investment income is paid out as non-eligible dividend (assuming top personal marginal tax rates). This difference grows to 2% in 2017.

This blog is not intended to be an exhaustive list of planning considerations in light of recent tax rate increases. Accountants, lawyers, and their clients will have no choice but to consider such changes and adjust course accordingly.