# Update on Liberal Federal Income Tax Changes

During the 2015 federal election campaign the leader of the Liberal Party of Canada, Justin Trudeau, unveiled his party's platform pledging to deliver change for middle class Canadians. The Liberal Party campaigned on strengthening the middle class by way of implementing 'real change'.

This publication summarizes some of the key tax pledges made by the newly elected government during its campaign as well as some updates from recent developments on its campaign promises since the new government convened on December 3, 2015.

## Notice of Ways and Means Motion – Released December 7, 2015

### Changes to Federal Personal Tax Rates

On December 7, 2015 Finance Minister Bill Morneau released further details on this new tax reform with the presentation of a **Notice of Ways and Means Motion** ("NWMM") in Parliament to formally introduce certain tax measures from the Liberal election platform. This NWMM seeks to amend the Income Tax Act by lowering the income tax rate for Canadians earning between $45,282 and $90,563 per year from 22% to 20.5%. This reduced rate would translate into a maximum tax savings of approximately $679 per individual. In keeping with its campaign promise, the motion also provides for a new top federal tax bracket on taxable income earned over $200,000 of 33%. This new rate is 4% higher than the existing top federal personal tax rate of 29%.

These changes are to take effect January 1, 2016. The table below outlines the existing and proposed 2016 personal federal income tax brackets and rates:

**Existing and proposed 2016 personal federal income tax brackets and rates**

| Taxable Income | Existing Rate (%) | New Rate (%) |
|---|---|---|
| Up to $45,282 | 15.0 | 15.0 |
| $45,282 - $90,563 | 22.0 | 20.5 |
| $90,563 - $140,388 | 26.0 | 26.0 |
| $140,388 - $200,000 | 29.0 | 29.0 |
| Over $200,000 | 29.0 | 33.0 |

For further details regarding the existing and proposed combined top marginal tax rates by province, please refer to the appendix. Note that the 4% federal tax increase for 2016 does not automatically translate to a higher tax rate of 4% for incomes exceeding $200,000 in all provinces because of some provincial tax adjustments already scheduled for 2016. Most notably, top rate taxpayers in Alberta will face a combined tax increase of 7.75% on ordinary income (e.g. salary, interest) resulting from the 2016 provincial and proposed federal tax increases.

With this NWMM confirming that the expected personal tax rate increases to Canadians with taxable incomes over $200,000 will take effect in 2016, affected individuals may wish to consider the possible benefit of accelerating the recognition of discretionary income or capital gains to 2015. However, there are many implications to consider when increasing taxable income, such as the impact to required quarterly tax instalments, OAS clawback, alternative minimum tax, timing of discretionary deductions (such as RRSP contributions), and cash flow, amongst others.

Ultimately, for high rate taxpayers the decision to dispose securities to realize capital gains or otherwise create income in 2015 depends on a "trade-off" of the acceleration of the timing of taxation to 2015 to access a potentially lower marginal tax rate versus deferring the realization of any income/gains under an existing investment strategy, but potentially incurring tax at a higher rate in 2016 or further in the future. As such, individuals should consult with their tax advisors to consider the potential impact of these tax rate changes to them (which varies by province as noted in the appendix), including preparing a 'pro-forma' tax estimate, to determine if any planning should be undertaken before 2016.

### TFSA Annual Contribution Limits

Starting in 2009 and in each year thereafter, qualifying taxpayers are entitled to a specified annual contribution limit to a tax-free savings account (TFSA). The 2015 federal budget increased the TFSA annual contribution limit from $5,500 to $10,000. However, another key pledge by the newly elected government was to roll the annual TFSA contribution limit back to $5,500. It was widely believed that this promise was to be implemented in 2016 and the NWMM tabled on December 7, 2015 confirmed this expectation. Effective January 1, 2016, the amount of contribution room allocated each year to a qualifying individual will be returned to its original level of $5,000, indexed to inflation for each year after 2009 and rounded to the nearest $500. **On this basis, an individual's TFSA limit will be $5,500 for 2016. However, the government confirmed that the TFSA annual contribution limit for 2015 will remain at $10,000.**

### Consequential Tax Changes Announced

The government also announced the following consequential tax changes in the NWMM which result from the new 33% top federal tax rate, effective for the 2016 and subsequent taxation years:

### Trust and Estates

Trust and estates will also be subject to flat top rate taxation at this new 33% federal tax rate. As noted in our BMO Wealth Management publication "One-time Planning Opportunity for Testamentary Trusts in 2015", new tax legislation coming into effect on January 1, 2016 will align testamentary trusts (which are trusts created at death, typically in the deceased's Will) with inter-vivos trusts (i.e., trusts created during one's lifetime) to apply a flat tax rate at the top personal marginal rate to any income retained in the trust. However, graduated rate estates and qualified disability trusts will not be subject to these forthcoming changes and will remain subject to the graduated rate system (including the 33% rate on taxable incomes exceeding $200,000, effective in 2016).

### Kiddie Tax

Certain income splitting arrangements involving minor children, such as the payment of taxable dividends from private corporations directly (or indirectly through a trust) to a minor, may be subject to the 'Tax on Split Income'. This so-called "kiddie tax" applies the top rate of taxation to the affected income, instead of the marginal tax rate that would otherwise apply given the child's low income. Effective in 2016, the "kiddie tax" rate will also increase to the new 33% top federal tax rate on affected income.

### Donation Tax Credits

Currently, individuals are able to claim a donation tax credit that is equal to the top federal marginal tax rate of 29% on qualifying charitable donations over $200. As part of the motion tabled on December 7, 2015 the government proposes to amend the calculation of the federal charitable donation tax credit to allow higher income donors to claim a 33% federal tax credit, but only on the portion of donations made from income that is subject to the new 33% top marginal tax rate. However, top rate taxpayers should note that this 33% donation tax credit rate is only available for donations made after 2015 and will not be available for donations carried forward from a prior year to 2016 or thereafter.

### Investment Income of Private Corporations

Given that corporate tax rates are generally lower than personal tax rates, special refundable taxes are imposed on investment income of private corporations in order to limit the ability of individuals to defer taxation by holding investments in a private corporation. The 'integration' tax system for private corporations, which seeks to ensure consistency in taxation between individuals earning investment income personally or through a private company, will also be amended to ensure its effectiveness with the new highest personal tax rate. Specifically, increases have been proposed to the (refundable) corporate tax rates on investment income and the rate at which corporate taxes are refunded (from RDTOH) on taxable dividend payments, effective January 1, 2016.

## Other Possible Future Tax Changes

### Employee Stock Options

In its election platform, the federal Liberal government indicated that potential changes to the taxation of employee stock options may be forthcoming. In particular, the following paragraph excerpted from the Liberal party platform provides some insight into these possible changes:

> A starting point would be to set a cap on how much can be claimed through the stock option deduction. The Department of Finance estimates that 8,000 very high-income Canadians deduct an average of $400,000 from their taxable incomes via stock options. This represents three quarters of the fiscal impact of this deduction, which in total cost $750 million in 2014. Stock options are a useful compensation tool for start-up companies, and we would ensure that employees with up to $100,000 in annual stock option gains will be unaffected by any new cap.

By way of background, employee stock options (issued by Canadian public companies) are generally taxed at the time the employee exercises the option to acquire a share of their employer's capital stock under the terms of the stock option employment agreement. The taxable employee benefit included in their income is equal to the amount by which the fair market value of the underlying security, at the time of acquisition, exceeds the amount paid by the employee to acquire the security (i.e., the exercise price). However, provided certain conditions are met, the employee may be able to deduct 50% of the amount included in income, with the result that the taxable benefit relating to the exercise of the stock option is taxed at rates similar to capital gains (though it is still treated as employment income). The above comments from the Liberal platform created a great deal of concern for Canadians with vested but unexercised stock options, prompting consideration of immediate exercise in order to avoid significantly higher taxes associated with a potential limit to the availability of the 50% deduction in the future.

However, in his comments on November 20, 2015 following the introduction of the Liberal government's first fiscal update, Finance Minister Bill Morneau confirmed that any changes to the taxation of stock options would not be retroactively implemented, effectively grandfathering any options issued before the date that any potential future changes to stock option taxation are announced.

The motion tabled to Parliament on December 7, 2015 did not contain any further commentary on this issue however the Finance Minister noted in his earlier update that no conclusion on how to change the tax treatment of stock options has yet been reached and this issue would be reviewed over the next few months. As such, new measures affecting stock option taxation may be included in the upcoming 2016 federal budget.

## Family Tax Cut

As noted in our BMO Wealth Management publication entitled "Tax Changes Assist Canadian Families", the former Conservative government introduced an income splitting measure, the family tax cut (FTC), in 2014. Specifically, a new federal non-refundable tax credit was created for couples with children under the age of 18. The FTC allows the higher income spouse to notionally transfer up to $50,000 of taxable income to a lower income spouse, to a maximum tax savings of $2,000 from this credit. The Liberal government also campaigned on the promise of cancelling this tax credit and this intention was confirmed in the Finance Minister's announcement on December 7 wherein he noted that it will be eliminated effective for the 2016 and subsequent years. Although no proposals to amend this legislation were provided in the NWMM, it is expected that this repeal will be included in the Liberal's 2016 federal budget.

## Private Corporation Small Business Tax Rates

In 2015, the former Conservative government implemented changes to gradually reduce the small business tax rate from 11% in 2015 to 9% by 2019 on the first $500,000 of qualifying active business income earned by a Canadian-Controlled Private Corporation (CCPC). The new Liberal government intends to proceed with this 2% reduction to the federal small business deduction; however, they have not specified the implementation timeframe. The Liberal platform did however indicate that they would review the use of CCPCs by high-income individuals as an income splitting tool. Unfortunately, no further details have yet been provided by the new government regarding possible changes - beyond the existing tax avoidance rules, such as corporate attribution and the "kiddie tax", that are currently in place to prevent income splitting techniques using CCPCs.

## Other Notable Pledges

The Liberal election platform also outlined a number of other tax-related initiatives, including:

**New Canada Child Benefit (CCB)** – A new CCB plan is to be introduced to replace the current Universal Child Care Benefit, Canada Child Tax Benefit and National Child Benefit Supplement. The new CCB will be a tax-free benefit and tied to family income levels and benefits will be reduced as income levels increase. It is expected that families with a household income of $200,000 or more will not receive any benefit under this program.

**Home Buyers` Plan (HBP) -** The platform also outlines plans to expand access to the HBP by allowing taxpayers affected by sudden and significant life changes to buy a house without a tax penalty. Life changes would include a job relocation, the death of a spouse, marital breakdown or a decision to accommodate an elderly family member.

**Canada Pension Plan (CPP) /Old Age Security (OAS)** – The Liberal government has also pledged to review the current CPP program along with the Provinces and Territories to enhance the CPP. With respect to OAS benefits, the Liberal government has pledged to retain eligibility at age 65. Under the former Conservative government, the age requirement was proposed to increase to 67 years of age.

## Summary

The above income tax measures introduced in the recent **Notice of Ways and Means Motion** are only proposals at this stage, however it is expected that these measures will formally be enacted into law, effective 2016. As these proposals (and the possible future additional Liberal tax measures) outlined above are wide-ranging and may have significant implications to your particular tax situation, you should consult with your tax advisors for specific advice and direction on how your particular situation may be affected by these tax changes.

The **Update on Liberal Federal Income Tax Changes** was developed by our in-house experts in the Enterprise Wealth Planning Group: **John Waters**, Vice-President, Head of Tax & Estate Planning and **Dante Rossi**, Senior Manager, Tax & Estate Planning.

For more articles visit **bmowealthexchange.com**.

## Appendix

Existing and proposed combined top marginal tax rates by province

| Province | Ordinary Income | | |
|---|---|---|---|
| | 2016 | 2015 | Increase |
| British Columbia | 47.70% | 45.80% | 1.90% |
| Alberta | 48.00% | 40.25% | 7.75% |
| Saskatchewan | 48.00% | 44.00% | 4.00% |
| Manitoba | 50.40% | 46.40% | 4.00% |
| Ontario | 53.53% | 49.53% | 4.00% |
| Quebec | 53.31% | 49.97% | 3.34% |
| New Brunswick | 58.75% | 54.75% | 4.00% |
| Nova Scotia | 54.00% | 50.00% | 4.00% |
| Prince Edward Island | 51.37% | 47.37% | 4.00% |
| Newfoundland | 48.30% | 43.30% | 5.00% |

| Province | Capital Gains | | |
|---|---|---|---|
| | 2016 | 2015 | Increase |
| British Columbia | 23.85% | 22.90% | 0.95% |
| Alberta | 24.00% | 20.13% | 3.87% |
| Saskatchewan | 24.00% | 22.00% | 2.00% |
| Manitoba | 25.20% | 23.20% | 2.00% |
| Ontario | 26.76% | 24.76% | 2.00% |
| Quebec | 26.65% | 24.98% | 1.67% |
| New Brunswick | 29.38% | 27.38% | 2.00% |
| Nova Scotia | 27.00% | 25.00% | 2.00% |
| Prince Edward Island | 25.69% | 23.69% | 2.00% |
| Newfoundland | 24.15% | 21.65% | 2.50% |

| Province | Eligible Dividends | | |
|---|---|---|---|
| | 2016 | 2015 | Increase |
| British Columbia | 31.30% | 28.68% | 2.62% |
| Alberta | 31.71% | 21.02% | 10.69% |
| Saskatchewan | 30.33% | 24.81% | 5.52% |
| Manitoba | 37.78% | 32.26% | 5.52% |
| Ontario | 39.34% | 33.82% | 5.52% |
| Quebec | 39.83% | 35.22% | 4.61% |
| New Brunswick | 43.79% | 38.27% | 5.52% |
| Nova Scotia | 41.58% | 36.06% | 5.52% |
| Prince Edward Island | 34.22% | 28.70% | 5.52% |
| Newfoundland | 38.47% | 31.57% | 6.90% |

| Province | Non-eligible Dividends | | |
|---|---|---|---|
| | 2016 | 2015 | Increase |
| British Columbia | 40.61% | 37.99% | 2.62% |
| Alberta | 40.25% | 30.84% | 9.41% |
| Saskatchewan | 40.06% | 34.91% | 5.15% |
| Manitoba | 45.69% | 40.77% | 4.92% |
| Ontario | 45.30% | 40.13% | 5.17% |
| Quebec | 43.84% | 39.78% | 4.06% |
| New Brunswick | 51.75% | 46.89% | 4.86% |
| Nova Scotia | 46.97% | 41.87% | 5.10% |
| Prince Edward Island | 43.87% | 38.74% | 5.13% |
| Newfoundland | 39.40% | 33.26% | 6.14% |

**Note:** The combined 2016 tax rates do not reflect potential changes that the provinces may introduce to their 2016 provincial tax rates in light of the federal tax rate changes announced.

**Source:** PWC Tax Insights from High Net Worth/Private Company Services Issue 2015-50

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