Changes that could target higher-income Canadians in the next federal budget

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We have a date. Finance Minister Chrystia Freeland will deliver Canada's federal budget plan on March 28, giving us less than two weeks to speculate about what may – or may not – be included, which also means that time is running out to do any significant planning before potential tax changes. No one knows with any certainty what will be in the upcoming budget, but we can glean some insight on its potential themes from the 226-page pre-budget Report of the Standing Committee on Finance issued last week, which contained 230 separate recommendations for tax changes and spending.

Among the proposals, the following recommendation may set the tone: "Undertake a public review to identify federal tax expenditures, tax loopholes and other tax avoidance mechanisms that particularly benefit high-income individuals, wealthy individuals and large corporations and make recommendations to eliminate or limit them."

With that ominous theme in mind, here are some potential tax changes that could target higher-income Canadians, along with some potential planning tips.

Top tax bracket

The top federal tax rate of 33% currently kicks in at an income of more than $235,675 for 2023, which is a 6.3% bump in the threshold over 2022 as a result of the high inflation we've been experiencing over the past year. The NDP's pre-election platform hoped to increase the top rate by two percentage points to 35%. If enacted, this could bring the top combined marginal tax rate, once provincial tax is factored in, to approximately 56% in British Columbia, Ontario, Quebec and Nova Scotia, and to 57% in Newfoundland and Labrador.

A similar proposal to bump up the top rate for the highest income earners was recently included in United States President Joe Biden's budget announcement earlier this month. He called for a top federal income tax rate of 39.6%, up from 37%, for taxpayers earning more than USD$400,000.

Surplus strips

The government may decide to shut down a popular private corporation tax-planning arrangement that some sophisticated taxpayers have been employing to distribute corporate surplus (essentially, tax-retained earnings) from their corporation at capital gains rates, rather than at the higher rates for Canadian dividends, or via the payment of a salary or bonus.

The Canada Revenue Agency has previously attempted to challenge surplus strip transactions, but the courts have generally held that this type of planning is acceptable, and doesn't violate the general anti-avoidance rule, since the *Income Tax Act* doesn't contain a general policy requiring shareholders to remove their surplus via a dividend rather than a capital gain.

The government tried to shut down this type of planning as part of its private corporation tax reforms in 2017, but those proposals were ultimately abandoned after significant public criticism.

Alternative minimum tax

Last year's federal budget noted that "some high-income Canadians still pay relatively little in personal income tax as a share of their income." To address this, the government announced a formal review of the alternative minimum tax (AMT), the results of which were originally supposed to come out in last fall's economic update. Instead, the government stated that a "detailed proposal and path for implementation" would be released in the upcoming budget.

Of course, we already have a federal AMT at a 15% rate. The primary reasons why some high-income Canadians pay low effective rates of tax has nothing to do with nefarious tax planning. For the most part, high-income earners are doing nothing more than claiming registered retirement savings plan deductions, charitable donations and dividend tax credits, and earning half-taxable capital gains.

South of the border, Biden's recent budget included a proposal to introduce a new 25% minimum tax on individuals whose net worth is more than US$100 million. This new tax would be different, in that it would be imposed on both income and unrealized capital gains for the wealthiest 0.01%.

Capital gains inclusion rate

Finally, no discussion of potential budget changes would be complete without at least touching on the capital gains inclusion rate. Currently set at 50%, you may recall that the NDP's platform proposed a hike to 75%.

In preparation for the budget discussions, Jonathan Rhys Kesselman, emeritus professor at Simon Fraser University's School of Public Policy, just released a paper entitled Pathways to Reform of Capital Gains Taxation in Canada that considers the case for increasing taxes on capital gains in Canada, and the implications for the upcoming reform of the AMT.

Kesselman shows there is a high concentration of capital gains among relatively few taxpayers and at very high incomes, and suggests that targeting an increased capital gains inclusion rate, either on large gains above a certain dollar amount or by filers with very high incomes, would sharply reduce the number of affected taxpayers, "easing both administration and compliance as well as public acceptance."

Biden's budget proposed a similar measure. The U.S. currently taxes long-term capital gains and dividends at a top rate of 20% federally, plus net investment income tax (NIIT) of 3.8%. The U.S. budget proposed taxing capital gains at a new top marginal income tax rate of 39.6% (plus raising the NIIT to five%) for taxpayers with more than USD$1 million of annual income.

If a change were announced to Canada's capital gains inclusion rate, it would likely be effective as of budget day (March 28). This means investors who fear a bump in the inclusion rate could consider accelerating any planning, including a potential rebalancing of their portfolios by taking gains now, thereby locking in a 50% inclusion rate. There are also more sophisticated tax strategies that could buy you some time if you're unsure what could happen to the inclusion rate on budget day.

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