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Canadian tax and a new government

Strategies for an escalating tax environment

With the election of the Liberal party on Monday, October 19th, Canada's tax landscape is expected to change. In particular, the Liberal platform has called for a new tax bracket to apply to income in excess of $200,000. In addition, family income splitting measures previously enacted are expected to be reversed. Concurrently, it is expected that other tax policy changes will be introduced, such as reductions to rates on lower income levels.

As with any change, it is prudent to consider the responses available to you and your private business. This special alert outlines general strategies to consider in response to an escalating tax rate environment.

What may change?

In addition to certain provincial income tax rate changes already enacted, the new Federal government is expected to increase the personal income tax rate from 29% to 33% on income above $200,000. This represents a significant increase to high-earning Canadians. Concurrently, earnings between $44,700 and $89,400 are expecting to see a decrease in the Federal tax rate from 22% to 20.5%.

Strategy 1: Accepting the status quo

The status quo is a strategy. Even if no adjustments to a compensation strategy are made, revisions to cash flow projections, personal spending expectations, and ongoing earnings are prudent. This includes both the changes in after tax cash for individuals from the expected adjustments to the rates for the top and middle income tax brackets, and also the increased tax burden many families may face as a result of the anticipated elimination of the Family Tax Cut credit.

Strategy 2: Accelerating income

While prepaying tax may be counterintuitive, it represents a considerable tax savings opportunity. Many private companies will accrue a bonus at year-end and then pay that bonus approximately six months later. This creates a deferral of the personal tax burden for six months; however, in an escalating rate environment that deferral could come at a cost of 4% incremental Federal tax. By accruing and paying the bonus on December 31, 2015, as opposed to deferring the payment to 2016, the rate of tax is expected to be 4% lower. In effect, paying now instead of in 2016 could generate a 4% return for most of Canada.

The amount of bonus and/or salary that is paid prior to December 31st should also be examined within the context of the existing rules for the deductibility of expenses to maximize the amount of the payment. While the personal tax on the bonus paid would be accelerated, the tax savings resulting from the bonus could be considerable. If the payment triggered a corporate loss that became available to carry forward to future tax years, the deduction could be used when corporate income tax rates may be higher, such as the expected 27% corporate tax rate in Alberta in 2016.

Another area to consider is your personal investment portfolio and the tax savings that may result from realizing accrued gains on certain securities that you may anticipate selling in 2016. By realizing those gains in 2015 instead of 2016, you could add 2% to your after-tax return.

The timing of the anticipated rate increase is still unknown but expected to be effective at some time in 2016.

Strategy 3: Reduce discretionary deductions

Many deductions available to taxpayers are discretionary. Although the deductions claimed in 2015 are valuable, deferring the deductions until 2016 could create an incremental 4% benefit personally with the potential change in personal tax rates. For example, an RRSP deduction claimed by a taxpayer in the top federal income tax bracket in 2015 could be worth a maximum of 29% in tax savings. Comparatively, claiming that same deduction on the 2016 personal tax return could be worth 33% federally. Where there are provincial personal income tax increases, the deduction in 2016 could be enhanced.

While corporate income tax rate changes are not expected to be as significant, the same consideration for evaluating the timing of the use of deductions or losses can be applied.

Strategy 4: Income deferral and income splitting

Often private companies and their owners will undertake a “freeze” transaction to help manage generational transfers of a business, while also helping improve the predictability of the tax liability on the death of a shareholder. These strategies often involve a “wasting freeze”, whereby the preferred shares received as part of the freeze transaction are redeemed in small blocks annually to help spread a tax burden across a longer period of time. This makes tax payments easier to manage from a cash flow perspective. Given the increase in rates, it may be prudent to consider ceasing those preferred share redemptions and deferring that income for a longer period of time. In this case, strategies should be focused instead on managing the tax liability on death if the funds from the redemption are not otherwise required from a personal cash flow perspective.

Many “freeze” transactions also involve the creation of a family trust to help handle the ownership of shares, with decisions being made related to those shares by the trustees. Family trusts, in addition to general estate planning benefits that they can provide, also create an opportunity to help split income within a family or a broader group. With the expected cancellation of the Family Tax Cut credit, which effectively allowed for some degree of income splitting within a family, the use of a family trust to help manage income levels within a family is expected to again carry more value.

Summary

Given the potential escalation in tax rates facing Canadian private business owners, now is an opportune time to revisit how your tax affairs are managed with your tax advisor. Deloitte Private, Canada’s largest professional services advisor to private clients, can help. As your trusted advisor, we are focused on your future – looking ahead to anticipate your needs and aspirations to continue building a prosperous future. Our focus is getting you there… and beyond.

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Your dedicated team

Heather Evans
Canadian Managing Partner, Tax
heevans@deloitte.ca
416-601-6472

Atlantic
Jim MacGowan
jmacgowan@deloitte.ca
902-721-5697

Quebec
Dominic Vendetti
dvendetti@deloitte.ca
450-978-3527

Ontario
David Mason
davmason@deloitte.ca
613-751-6685

Ontario
Karen Wilkinson
kawilkinson@deloitte.ca
519-650-7800

Toronto
Michael Belz
mbelz@deloitte.ca
416-643-8712

Brian Brophy
National Deloitte Private Tax
bbrophy@deloitte.ca
416-601-5844

Winnipeg
Brian Anderson
bjanderson@deloitte.ca
204-944-3628

Saskatoon
Mike D. Smith
michsmith@deloitte.ca
306-343-4453

Alberta
Mike Bird
mbird@deloitte.ca
403-267-1852

Alberta
Trevor Thomson
tthomson@deloitte.ca
403-503-1391

British Columbia
Dallas McMurtrie
dmcmurtrie@deloitte.ca
604-640-3278