The impact of high personal and corporate tax rates

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Recently, I had the honour and pleasure of speaking at one of Canada's premier tax and estate planning conferences. While listening to some of the sessions, a number of speakers commented on Canada's high tax rates as well as Alberta's tax rate increases and compared such resulting top rate (48% on ordinary income) to Ontario's rate (almost 54% on ordinary income). It was clear from the various updates that there was little sympathy for Albertans who gripe about the large rate increases in such a short period of time given the fact that there are other provinces with higher rates. This theme irritated me for reasons I will explain below.

Income tax rates and the impact they have on overall economic behaviour is a surprisingly complex subject involving economics, tax policy, and psychology. When discussing tax rates, some commentators often point out that Alberta has the lowest tax rates in the country – even after the increases. Well, not quite true (BC and some territories have lower rates) but fine… you win on that shallow comparison. They may also point out that Canada's tax rates are low by historical standards. In fact, in 1971, Canada's highest personal income tax rate was 80%! Is the 1971 tax rate a justification for today's rates? No. 1971 was a very different time from today. Back then, eye-popping top marginal tax rates were common amongst countries. In addition, it should be pointed out that the 80% top rate in 1971 did not kick in until the marginal rate bracket was $400,000, which is equivalent to about $2,500,000 in today's dollars when adjusted for inflation. Comparatively, the Alberta top marginal rate today starts applying for income over $300,000. Another important point to recall is that countries, including Canada, had tax regimes that were much less robust and less broad than today, so it was relatively easy for businesses and high net worth individuals to plan their affairs to minimize their income; not so easy today as tax legislation and enforcement has become much, much tighter (and rightly so).

With the recent rise of left-leaning federal and provincial governments in Canada, the temptation to increase tax rates has been hard to resist. The tables below show the reversal of historical tax rate decreases both personally and corporately.

Highest Personal Tax Rates on Ordinary Income

	1996	2014	2016
Ontario	52.92%	49.53%	53.53%
Alberta	45.58%	39.00%	48.00%
California	45.22%	45.22%	45.22%
Texas	39.60%	39.60%	39.60%

General Corporate Rates

	1996	2014	2016
Ontario	44.62%	26.50%	26.50%

Alberta	44.62%	25.00%	27.00%
California	41.05%	40.75%	40.75%
Texas	35.00%	35.00%	35.00%

A quick review of the above tables reveals two obvious observations. In the span of two years, Canada has managed to reverse course on personal tax rates and bring us back to personal tax rates that are higher than they were 20 years ago! The second observation is that Canada's corporate rates are rather low compared to the United States. However, the low corporate rate tax rate that Canada has used favourably to attract business and capital is likely to be short-lived given the new US administration's commitment to dramatically reduce US corporate rates. While it is anyone's guess when such reductions might ultimately come to pass, there have been speculations about proposals to reduce such rates to a low of 15% and a high of 25%. Even on the high side, this would compare favourably to many Canadian provinces.

The consistent message from the Federal and Alberta government is that the rich need to "…pay a little bit more" (even as recently as yesterday in the House of Commons when the Prime Minister boasted about his government implementing tax rate increases to tax "the 1%" more). Apparently, if you make $200-$300K of personal income, you're rich. But what if you have a lot of capital at risk in order to make such income? Are you still rich? Depends on your point of view I guess. From my point of view, entrepreneurs are special people. They often risk much of their wealth to chase their passion and along the way create jobs and hopefully get a decent rate of return on their investments. Is such risk worth taking if they are subjected to high personal and corporate rates that reduce their overall rates of return?

In a blog posting about Alberta's tax rate increases in 2015, I stated: "…*we are concerned that the policy foundations may negatively affect Alberta's resource, technology, innovation and entrepreneurial sectors*." I'm obviously no economist and therefore not qualified to comment on the impact that tax rate increases have on the overall elasticity of the Canadian economy. What I am, however, is a tax practitioner who advises entrepreneurs and investors and I'm often on the front end of planning to deploy capital into Canada and specifically, Alberta. Accordingly, my 2015 comment was made as a practitioner concerned that Alberta's economy would be negatively affected by such tax rate increases. I was also concerned about the compounding impact of low oil and gas revenues which Alberta depends greatly upon.

Since 2015, our firm has seen a dramatic reduction of capital coming into Alberta and Canada. Why? The lingering low oil and gas prices are obviously one of the main reasons, but tax rate increases have certainly contributed to this reduction which, overall, has resulted in an unfriendly investor environment. (I'll resist the urge to comment on other non-tax matters that have contributed to this environment). The analogy I like to use is that of a garden. If the garden is properly tilled, fertilized, weeded, watered and cared for, then properly planted seeds will often thrive. If one or more of those elements are removed, then the seeds may not thrive like they once did. And ultimately, such seeds would likely thrive in another garden that has all of those good elements. This is what is happening in Alberta.

The capital that once thrived in Alberta's garden is now fleeing to better gardens. In addition to being on the front-end of capital not being deployed in Alberta, our firm is also on the front-end of capital leaving Alberta and Canada. When large foreign corporations leave Canada – like many have done recently in divesting themselves of their oil sands interests – such news often hits the front pages of the newspapers. What does not hit the newspapers is when entrepreneurs or wealthy individuals leave Canada.

I have been practicing tax for about 23 years. Over my career, I have been involved in many client scenarios where individuals desire to become non-residents of Canada and I have helped them deal with the resulting tax issues. Without a doubt, over 95% of such cases that I have worked on historically were the result of lifestyle choices. In other words, virtually all of the cases involved entrepreneurs and families that simply wanted to live permanently outside of Canada for non-tax reasons.

When Canadian resident individuals become non-residents of Canada, they are subjected to Canada's "departure tax". Overly simplified, paragraph 128.1(4)(b) of Canada's Income Tax Act will deem such an individual to have disposed of all of their worldwide assets at the fair market value thereof at the time of becoming a non-resident. Any resulting gains are therefore taxable. There are a number of exceptions to the departure tax but such exceptions are narrow with the idea being that such assets/deferred income will eventually be subject to Canadian taxation.

In the last 20 months or so, our firm has been involved in many departure tax planning assignments for entrepreneurs and other individuals. The number of such assignments equates to approximately 20 times the number of assignments that I have previously worked on in my entire career. The aggregate dollar value of such recent projects is very significant. While such assignments are fascinating and provide a great intellectual challenge, I am personally saddened every time I work on a departure tax plan since great assets – both the individuals and the dollars – are now not available for Canada. Canada needs great entrepreneurs and investment. Why the dramatic increase in departures? Without question, the reason has been tax rate increases with such individuals looking elsewhere to deploy their capital in a much better tilled, fertilized, weeded, watered and cared for garden.

Where has most of the capital gone to in our planning assignments? Most of it has gone to the US, some to Europe and some to other countries. If the US is successful in actually reducing its corporate or personal tax rates, I fully expect the frequency and magnitude of such departures to accelerate. In addition, if the private corporation consultation study that the Department of Finance announced in its recent federal budget deploys measures that further attack entrepreneurs (which it certainly sounds like such attacks are coming), then I expect such measures will add fuel to this departure trend. As economists and investment bankers often trumpet, capital is mobile and unemotional. It will go to where it can receive greater returns. When I discuss some of these issues with my left-leaning friends, the usual response to my griping is "well, let them leave then… Canada is a great country." Yes, I agree that Canada is a great country but to "let them leave" is not the proper solution for our society. Such individual and monetary assets are not easily replaceable.

Alberta's per capita GDP has consistently been the highest of all provinces in Canada and is one of Canada's most important economic engines. It is a "have" province that has consistently contributed by way of transfer payments to the "have not " provinces. On balance, Alberta's success has been due to its resource rich assets and friendly policies for entrepreneurs – including lower and competing tax rates – to deploy their assets in Alberta's gardens. While I'm confident that better times will return to Canada and Alberta (which higher oil and gas prices will certainly help), Canada needs to protect its assets. Taxing such assets out of existence does not help. And suggesting that Alberta has nothing to complain about when comparing its overall tax rates to other provinces doesn't help either (although I certainly am sympathetic to a 54% top tax rate in Ontario which I find outrageous).

I'm optimistic some sanity will ultimately be restored to Canada's overall tax rates so as to make our gardens fertile once again for entrepreneurs and investors.