The Top 3 Tax Changes to Look For With the “New” Liberal Minority Government

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One of my favourite strategy/management authors was Peter Drucker. He was a quote machine, but one of my favourites was:

> *Trying to predict the future is like trying to drive down a country road at night with no lights while looking out the back window.*

With that in mind, let’s take a drive down a country road with no lights while looking out the back window and predict some Canadian tax changes.

Now that the Speech from the Throne to Open the First Session of the 43rd Parliament of Canada has been delivered, it’s time for all the pundits to start guessing what we can expect from Parliament. And for tax geeks, it’s time to start predicting what tax goodies we can expect. The speech was very short on specifics and deliverables, but these two paragraphs caught my attention:

> *And in this new mandate, the Government will provide even greater support to the middle class and the most vulnerable Canadians by pursuing tax fairness, continuing to invest in people, and growing the economy.*
>
> *As its first act, the Government will cut taxes for all but the wealthiest Canadians, giving more money to middle class families and those who need it most.*

On December 9, 2019, The Department of Finance released a Backgrounder and Notice of Ways and Means Motion to fulfill the Liberal Party’s election promise to increase the tax credit known as the basic personal amount (to be phased in over four years) for everyone but the “wealthy” (and thus the second paragraph highlighted above from the Throne Speech would be acted upon). Specifically, the increase in the basic personal amount will be gradually reduced for individuals with net incomes above $150,473 in 2020 and eliminated for individuals with net incomes over $214,368 in 2020 (the threshold for the top tax bracket). The Budgetary Parliamentary Officer estimates that this will cost the government approximately $2.8 billion next year, eventually increasing to approximately $6 Billion per year once fully implemented. Not inexpensive. For an interesting perspective on this recent proposal discussed in the Globe and Mail by columnist Andrew Coyne, have a look at his article here (subscribers only).

Whenever people like me see the phrase “tax fairness” – as highlighted above in the first paragraph from the Throne Speech – in the absence of a comprehensive review of our entire tax system (which the current government has no interest in doing), we know that this is code for only one thing: direct or indirect tax increases. Combined with the election promise in the Liberal Party's election platform to "…*undertake a comprehensive review of tax expenditures to ensure that wealthy Canadians do not benefit from unfair tax breaks,*" the foreshadowing of imminent tax increases is very strong. (As an aside, the Liberals undertook a comprehensive review of tax expenditures in 2016. Not sure how many times a comprehensive review of tax expenditures is needed in a three year period, but ultimately this is no doubt a promise to target the wealthy).

Given this, here are my top 3 tax predictions to watch for from this government.

1. Increase in Capital Gains Inclusion Rates?

Prior to 1972, capital gains realized by taxpayers were not taxable in Canada. The Report of the Royal Commission on Taxation released in 1966 recommended that capital gains be fully taxable since "a buck is a buck is a buck." After much debate, the government – effective January 1, 1972 – implemented tax reform, which included capital gains as taxable, but only at a 50% inclusion rate. This inclusion rate stayed that way until 1988 when the government of the day increased the inclusion rate to 2/3. In 1990, the inclusion rate was increased to 75%, and it stayed that way until 1999. In 2000, the inclusion rate was first reduced to 2/3, and then to 50%, and it has stayed that way ever since.

Every year for roughly the last ten years, many "tax people" and pundits make predictions that the inclusion rate is going up. Some tax professionals have even made an annual business out of encouraging people to crystallize any unrealized gains before the predicted increase. And every year, such pundits have been wrong. But what about this year? With the Liberals effectively promising direct or indirect tax increases, could 2020 be the year that the capital gains inclusion rate increases? A strong maybe.

The NDP's election platform advocated for an inclusion rate increase to 75%, which the Parliamentary Budget Officer estimated would raise tax revenues by approximately $8 billion…a huge number. When you combine the NDP's election promise with the Liberal Party's promise to undertake a comprehensive tax expenditure review with an eye to eliminating "unfair tax breaks" for the wealthy, there is a distinct possibility that the Liberal minority government could move forward with such an increase. Would such an increase be an across the board increase? Or would the higher inclusion rate only apply to higher income earners? Your guess is as good as mine. But let's just say that, this year, I am telling clients that there is a distinct possibility that the capital gains inclusion rate will increase, and they should consider taking precautionary measures. There are many reasons why the government should not proceed with an increase (for a good article on such reasons, have a look at this link). Still, I believe this government is more focused on "income equalization" than on good tax policy, and may proceed despite these risks.

2. Restrictions on Interest Expense Deductions?

Our firm wrote about this issue in our October 2019 election blog, but unfortunately, the mainstream media has not given this issue much coverage. This is what we wrote at the time:

> *For corporations with net interest expenses of more than $250,000, the Liberals will limit the amount of interest a corporation may deduct in computing its income to no more than 30% of its income before interest, taxes, depreciation and amortization (EBITDA). This measure is intended to address companies over-leveraging with debt, and reducing corporate income with interest expense.*

The NDP has jumped on the bandwagon, proposing to limit interest deductions to 20% of EBITDA for companies with net interest expense of more than $150,000.

This will be a major change in our corporate tax regime, and details are needed to assess the impact this will have on Canadian businesses. One observation we will make is that when the US adopted similar limitations on interest deductions, the US concurrently cut the corporate income tax rate from 35% to 21%. The Liberals are proposing a similar interest limitation without the accompanying corporate tax rate cut.

In my opinion, this proposal, if implemented, would have the largest impact on Canadian businesses. Let's use an example with the following facts to illustrate.

- Opco, a Canadian company, meets the application threshold of these rules;
- Opco borrowed $5 million at 8% interest, and incurred $400,000 interest expense;
- Opco's income statement reveals the following
    - Revenue: $900,000
    - Operating Expense: $300,000
    - Depreciation: $150,000
    - Interest expense: $400,000
    - Net income before tax: $50,000

Given the facts above, Opco's EBITA = $600,000. If the interest deductibility restrictions are implemented, then out of the $400,000 interest incurred, only $180,000 would be deductible (i.e. $600K x 30%), thus requiring Opco to pay corporate tax on $270,000 of profits rather than the economic profits of $50,000. What would happen to the $220,000 of non-deductible interest? When the PBO costed this proposal, they suggested that the denied interest deduction may be carried back three years and forward 20 years.

This proposal is littered with concerns and issues. In my opinion, before implementation, extensive consultation is needed with the business community – especially for domestic interest amounts that are not being incurred as a vehicle to move income out of Canada. I have doubts that the Liberals will easily implement this proposal without a significant backlash from the business community. Still, the community should nevertheless be aware of this proposal and watch for it.

3. The End of Surplus Stripping?

"Surplus stripping" is a common phrase utilized in the tax community to describe transactions that are developed to extract after-tax corporate retained earnings ("surplus") in a fashion other than a taxable dividend. Most accountants learn in their university "Accounting 101" classes that the ONLY way – by definition – to extract such after-tax surplus out of a corporation and return it to shareholders is by way of a dividend. By extension, one could assume that all surplus extractions would thus be taxable dividends, but such is not the case. In many cases, it may be possible to circumvent dividend taxation and have such surplus taxed otherwise – usually in the form of capital gains. While there are some anti-avoidance surplus stripping provisions in the Income Tax Act already, these provisions have proven not to have the "teeth" that the government desires.

An attempt to curtail surplus stripping was made with the disastrous July 18, 2017, private corporation tax proposals. Those proposals were littered with errors, had major retroactive effects, were mean spirited and were ultimately abandoned after a significant backlash by the tax and business community. While many in the tax community do not disagree that blatant surplus stripping should be prevented, it will be a balancing act to find exactly how to do it without preventing legitimate commercial planning and to prevent the possibility of long-term double taxation.

Most agree that it is only a matter of time before new surplus stripping proposals are implemented. Accordingly, some tax advisors are recommending to their clients enter into surplus stripping transactions now before new measures are introduced. This may be a good idea, but careful consideration of each person's situation is required, and appropriate risk mitigation is needed before entering into such transactions.

Well, there you have it: My Top 3 List. But as good old Peter Drucker said:

> *The only thing we know about the future is that it will be different.*

There is no doubt that the tax future in Canada will be different. And potentially very different.