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LEGISLATIVE SUMMARY

Bill C-2: An Act to amend the Income Tax Act

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Any substantive changes in this Legislative Summary that have been made since the preceding issue are indicated in **bold print**.

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(Legislative Summary)

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1 BACKGROUND

Bill C-2, An Act to amend the Income Tax Act, was introduced in the House of Commons on 9 December 2015 by the Minister of Finance, the Honourable Bill Morneau.[1]

The bill changes federal personal income tax rates, reducing the second marginal tax rate from 22% to 20.5% and introducing a top marginal tax rate of 33% for a new tax bracket, that being taxable income exceeding $200,000. Other amendments to the *Income Tax Act* (ITA) are consequential, to account for the new 33% marginal tax rate and associated tax bracket.

As well, Bill C-2 reduces the annual contribution limit for Tax-Free Savings Accounts from $10,000 to its previous level. Under the legislation, the annual contribution limit is $5,500 starting 1 January 2016, which was the case for 2013 and 2014.

2 DESCRIPTION AND ANALYSIS

Bill C-2 consists of 10 clauses. Clause 1 makes changes to the marginal tax rates for personal income, while clauses 2 through 8 and 10 make consequential amendments to account for the new marginal tax rate of 33%. Clause 9 changes the Tax-Free Savings Account annual contribution limit.

2.1 Amendments to the Marginal Tax Rates for Personal Income (Clause 1)

Clause 1 amends sections 117(2)(*a–d*) and adds section 117(2)(*e*) to the ITA to change the marginal tax rates that apply to income earned by individuals. The taxable income amounts associated with tax brackets that existed prior to Bill C-2 are increased to reflect the annual indexation of taxable income amounts to inflation. With the changes introduced in Bill C-2, the following tax rates and tax brackets exist:

- The first marginal tax rate of 15% is not changed, but the highest income to which it is applied increases from $40,726 to $45,282.
- The second marginal tax rate falls from 22% to 20.5%, and applies to income between $45,283 and $90,563, an increase from $81,452.
- The third marginal tax rate is maintained at 26%, but applies to income between $90,564 and $140,388, an increase from $126,264.
- The fourth marginal tax rate is unchanged at 29%, but applies to income between $140,389 and $200,000; previously, this rate applied to all income exceeding $126,264.
- A 33% marginal tax rate is introduced, and it applies to income exceeding $200,000.

The amendments apply to the 2016 and subsequent taxation years.

2.2 Consequential Amendments

2.2.1 Charitable Donation Tax Credit (Clause 2)

Clause 2 amends section 118.1(3) of the ITA, which provides a tax credit for individuals who make donations to registered charities. Before the changes introduced in Bill C-2, the tax credit was calculated as 15% for the first $200 of donations and 29% for the amount of donations above $200; the 15% and 29% rates corresponded to the lowest and highest marginal tax rates that existed prior to the introduction of the bill. The tax credit will now be calculated as follows:

- 15% for the first $200 of donations;
- 33% for donations made by individuals who have annual taxable income exceeding $200,000, with this portion of the tax credit capped at the lesser of
  - the amount of donations above $200, or
  - the amount of the individual's taxable income for the year that exceeds $200,000.

  This means that the 33% tax that would be payable by the donor on annual income above $200,000 is reduced if the individual makes donations totalling more than $200; and
- 29% of the amount of donations above $200 that is not eligible for the 33% tax credit rate, because the donor does not have sufficient income exceeding $200,000 for the year. For example, if the amount of an individual's taxable income that exceeds $200,000 is less than the amount of donations above $200, then the difference between the two amounts is eligible for the 29% rate. The 29% rate also applies to the amount of donations above $200 made by individuals who have annual taxable income of $200,000 or less.

The amendments apply to donations made after 2015. Donations made in 2015 or earlier but claimed for the 2016 or later taxation years are not eligible for the 33% tax credit rate.

2.2.2 Income Earned by a Child (Clauses 3 to 4)

Clauses 3 and 4 change the tax rules for certain types of income earned by a child. These types of income are called "split income." Clause 3 amends the definition of "tax otherwise payable under this Part" in section 120(4)(*b*)(i) of the ITA by changing the applicable marginal tax rate from 29% to the "highest individual percentage for the year," that being the new 33% rate. Similarly, clause 4 amends section 120.4(2) of the ITA so that tax on split income is calculated at this new rate.

Clauses 3 and 4 apply to the 2016 and subsequent taxation years.

2.2.3 Income Earned by a Trust (Clause 5)

Clause 5 amends section 122(1)(*a*) of the ITA, which sets out the taxation rules for trusts. The tax rate for trusts rises from 29% to the highest individual percentage for the taxation year, that being the new rate of 33%.

The change is applicable for the 2016 and subsequent taxation years.

2.2.4 Taxation of Corporations and Shareholders (Clauses 6 to 8)

Clauses 6, 7 and 8 amend certain rules in relation to the taxation of corporations and their shareholders. Generally, the rate of tax paid by a corporation depends on the type of corporation, the type and source of income earned by the corporation, and the timing of distributions made by the corporation to its shareholders.

Certain types of income that are earned by corporations, such as investment income, are subject to special taxes in order to discourage individuals from deferring the payment of personal income taxes through the retention of profits earned by a related corporation and the delayed receipt of distributions, such as dividends. To prevent "double taxation" of income earned by such corporations, which occurs when the profits of a corporation are subject to tax at both the corporate level and the personal level, the corporation receives a partial refund of special taxes when it distributes taxable dividends to its shareholders. Another measure to prevent double taxation is the dividend gross-up and dividend tax credit system. This system provides a personal tax credit that accounts for some of the corporate income tax that has already been paid on the dividends that are distributed to shareholders.

Because the goal of the provisions designed to prevent double taxation is to integrate corporate and personal income tax rates in order that the amount of taxes paid by an individual is similar whether income is earned through a corporation or directly by the individual, amendments were made to these tax-relieving provisions to take into account the changes to the federal marginal tax rates for personal income.

Clause 6 amends section 123.3 of the ITA, which imposes a special refundable tax on the investment income earned by a Canadian-controlled private corporation (CCPC). A CCPC is a type of private corporation that is subject to certain tax rules. The purpose of this special refundable tax is to discourage the retention of investment income in the CCPC and the non-distribution of dividends, as this situation would delay the payment of income tax by shareholders on the dividends. As well, when combined with the other components that make up the corporate income tax rate, this special refundable tax allows the income tax rate applied on a CCPC's investment income to be close to the top marginal tax rate for personal income. With the changes introduced in Bill C-2, the special refundable tax rate increases from 6⅔% to 10⅔% to account for the new marginal rate of 33%. The provisions in the ITA that allow a CCPC to obtain a partial refund for this special refundable tax are described in discussion of clause 7, below.

The amendment applies to taxation years that end after 2015, and will be prorated for taxation years that begin before 2016.

Clause 7 amends various provisions in section 129 of the ITA, which set out the rules that allow a private corporation to obtain a partial refund for certain taxes paid on its investment income in situations where taxable dividends are distributed to shareholders. For example, the special refundable tax provided for in section 123.3 (see discussion of clause 6) and Part IV tax (see discussion of clause 8) are eligible for partial refunds under section 129.

The amount of tax that can be refunded is set out in the definition of “refundable dividend tax on hand” (RDTOH). RDTOH is a notional account that comprises taxes that a private corporation has paid to the Canada Revenue Agency on its Canadian and foreign “aggregate investment income.” Generally, aggregate investment income is income from capital gains and property income, the latter of which includes dividends. Because the calculations for the rate of refund must be adjusted to account for the new marginal rate of 33% for personal income, clause 7 makes the following changes:

- Section 129(1)(*a*)(i) is amended to increase the dividend refund rate for all private corporations from ⅓ of all taxable dividends to 38⅓% of all taxable dividends.
- Section 129(3)(*a*)(i), which applies only to CCPCs, is amended to change the percentage of a CCPC’s investment income for a year that can be included in the calculation of the CCPC’s RDTOH from 26⅔% to 30⅔% of aggregate investment income and from 9⅓% to 8% of foreign investment income. The decrease to 8% for foreign investment income is due to the increase in the special refundable tax rate from 6⅔% to 10⅔%.
- Section 129(3)(*a*)(ii), which takes into consideration the extent to which a CCPC has benefitted from the small business deduction or foreign tax credits, is amended to increase the percentage of a CCPC’s taxable income for a year that can be included in the CCPC’s RDTOH calculation from 26⅔% to 30⅔%. The section is also amended to adjust the gross-up factor for foreign non-business income from 100/35 to 100/38⅔. Foreign non-business income continues to be eligible for a foreign tax credit, which can be used to offset any Canadian taxes owed. The adjustment to the gross-up factor is required because of the increase in the special refundable tax rate from 6⅔% to 10⅔%.

The amendments are effective for taxation years that end after 2015, and are prorated for taxation years that begin before 2016.

Clause 8 amends section 186(1) of the ITA, which imposes Part IV tax – which is a particular special refundable tax – on “assessable dividends” that are received by a private corporation. The purpose of Part IV tax is to prevent individuals from holding taxable dividends in private corporations and thus deferring the payment of income tax on these dividends. After accounting for the dividend gross-up and dividend tax credit, the rate of Part IV tax is equal to the top marginal tax rate paid by an individual on taxable dividends. Part IV tax can be partially reduced by certain types of losses, such as non-capital losses or farm losses.

To account for the new marginal tax rate of 33% for personal income, the rate of Part IV tax rises from ⅓ of all assessable dividends to 38⅓% of all assessable dividends. As well, the percentage of non-capital losses and farm losses that may reduce Part IV tax increases from ⅓ of losses to 38⅓% of losses.

The amendments are applicable for taxation years that end after 2015. For taxation years that begin before 2016, the assessable dividends are taxed at the rate of 33⅓% for those received before 2016 and at the rate of 38⅓% for those received after 2015. The amendment in relation to losses is applicable for taxation years that end after 2015; for taxation years that begin before 2016, losses must be applied first to offset assessable dividends that are subject to the 38⅓% rate.

2.2.5 Definitions (Clause 10)

Clause 10 adds the definition of “highest individual percentage” to section 248(1) of the ITA to refer to the highest marginal tax rate for personal income. It also clarifies the definition of “appropriate percentage” in section 248(1) for consistency with the definition of “highest individual percentage.”

The amendments are effective for the 2016 and subsequent taxation years.

2.3 Amendments Concerning Tax-Free Savings Accounts (Clause 9)

Clause 9 amends section 207.01(1) of the ITA, which sets out the contribution limits for Tax-Free Savings Accounts (TFSAs) through the definition of “TFSA dollar limit.” For the 2015 calendar year, the TFSA contribution limit is $10,000. For subsequent years, the limit is $5,000, which was the limit when TFSAs were introduced, indexed to inflation – as calculated in section 117.1 of the ITA – to the nearest $500 for every year, beginning in 2009. Thus, for 2016, the limit is $5,500, as it was in 2013 and 2014.

The amendments are deemed to have come into force on 1 January 2016.

NOTES

1. On 7 December 2015, the Department of Finance provided the estimated federal fiscal cost of selected amendments in Bill C-2 for the current and five future fiscal years. See Department of Finance Canada, “Table 2: Fiscal Cost of Proposed Tax Changes,” *Backgrounder: Middle Class Tax Cut*.