Intelligence MEMOS

From: Brian Ernewein, Alexandre Laurin and Nicholas Dahir

To: Federal Budget Observers

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Re: **A new Alternative Minimum Tax for Canada?**

In the 1984 federal leaders' election debate, Brian Mulroney set the stage for the introduction of a personal minimum tax in Canada:

> *I think it's unfair that an individual not pay a minimum tax . . . . Should anybody in this country of wealth and substance in this country not pay tax? The answer's no. Yes, he should pay tax, and it should be a handsome tax ...*

Nearly 40 years later, the current government is promising a new minimum tax in this week's budget:

> *In Budget 2022, the government committed to examining a new minimum tax regime to ensure that all wealthy Canadians pay their fair share of tax. The 2022 Fall Economic Statement reaffirms this intent, and a detailed proposal and path for implementation will be released in Budget 2023.*

The current commitment has its roots in the 2021 Liberal election platform:

> *A re-elected Liberal government will: . . . .*
>
> *Create a minimum tax rule so that everyone who earns enough to qualify for the top bracket pays at least 15 percent each year (the tax rate paid by people earning less than $49,000), removing their ability to artificially pay no tax through excessive use of deductions and credits.*

It is, of course, open to the government to review the operation of the current personal alternative minimum tax (AMT), and perhaps well into its fourth decade it deserves re-examination. But the campaign platform suggests skulduggery on the part of taxpayers, and even the more measured language in the last budget – "These Canadians make significant use of deductions and tax credits, and typically find ways to have large amounts of their income taxed at lower rates" – seems intended to convey the impression of, if not impropriety, then at least inequity.

We were interested in testing this rhetoric, by trying to determine the extent to which lower federal tax rates imposed on some ostensibly higher-income taxpayers were attributable to aggressive tax planning, versus the application of standard – and generally well-accepted – tax provisions.

To do this, we started by replicating Chart 9.1 of Budget 2022, using Statistics Canada's Social Policy Simulation Database and Model. This may not be as accurate as Finance Canada's database/model, but it comes within a percentage point of the proportion of high-income taxpayers paying less than a 15 percent federal rate of tax (for the same year, 2019) and provides reasonable confidence in the rest of the analysis.

We then sought to identify common tax provisions that would contribute to these taxpayers having an average federal tax rate under 15 percent. The following chart sets out these provisions, and illustrates their impact.

In looking at the composition of taxable income for these individuals (i.e. average federal tax rate under 15 percent, or "under-15" category), we find that 89 percent of them reported capital gains, representing on average about two-thirds (64 percent) of their total gross income.

Given the 50-percent inclusion rate for capital gains, and a top federal tax rate of 33 percent for individuals (making the top rate of federal tax on capital gains 16.5 percent), it is unsurprising that most gains are subject to an average tax rate below 15 percent. For example, in 2019, where capital gains (not qualifying for the lifetime capital gains exemption) are an individual's sole income source, the average tax rate for this individual will exceed 15 percent only once capital gains cross the $1.5 million mark. With $50,000 of "ordinary" income, the individual's average tax rate will exceed 15 percent at $945,000 of capital gains; with $75,000 of ordinary income, the individual's average tax rate will exceed 15 percent at $650,000 of capital gains.

Given the significance of capital gains in this context, changes to their tax treatment would have a material impact on the average tax rate imposed on Canadian taxpayers. Simply eliminating the lifetime capital gains exemption, for those who were eligible, would result in a 13.4-percent reduction of tax filers in the under-15 category (they move up to the over-15 category).

Even more dramatically, if the capital gains inclusion rate were increased to 100 percent, a further 59.5 percent of the under-15 group would move to the over-15 category.

In other words, the current capital gains inclusion rate and lifetime capital gains exemption appear to be the reason that 72.9 percent of higher-income individuals were in the under-15 category in 2019.

As well, 83 percent of people in the under-15 category made RRSP contributions, equalling on average approximately 10 percent of their income. Denying the RRSP deduction (in addition to the capital gains changes) would result in a further 9.3 percent of people in the under-15 category moving to over-15.

Denying the charitable donation tax credit would remove another 4.8% of individuals from the under-15 category. Finally, denying the dividend tax credit would further reduce the pool of those in the under-15 category by 2.1 percent.

Overall, these provisions cumulatively explain 89 percent of the cases in which higher-income individuals were subject to an average federal tax rate below 15 percent, despite the existing AMT. Provisions related to capital gains explain most of it, but RRSP contributions and charitable donations also play a role.

We calculate that in 2019 there were a little fewer than 40,000 individuals who reported more than $400,000 in total income and faced a federal tax rate below 15 percent.

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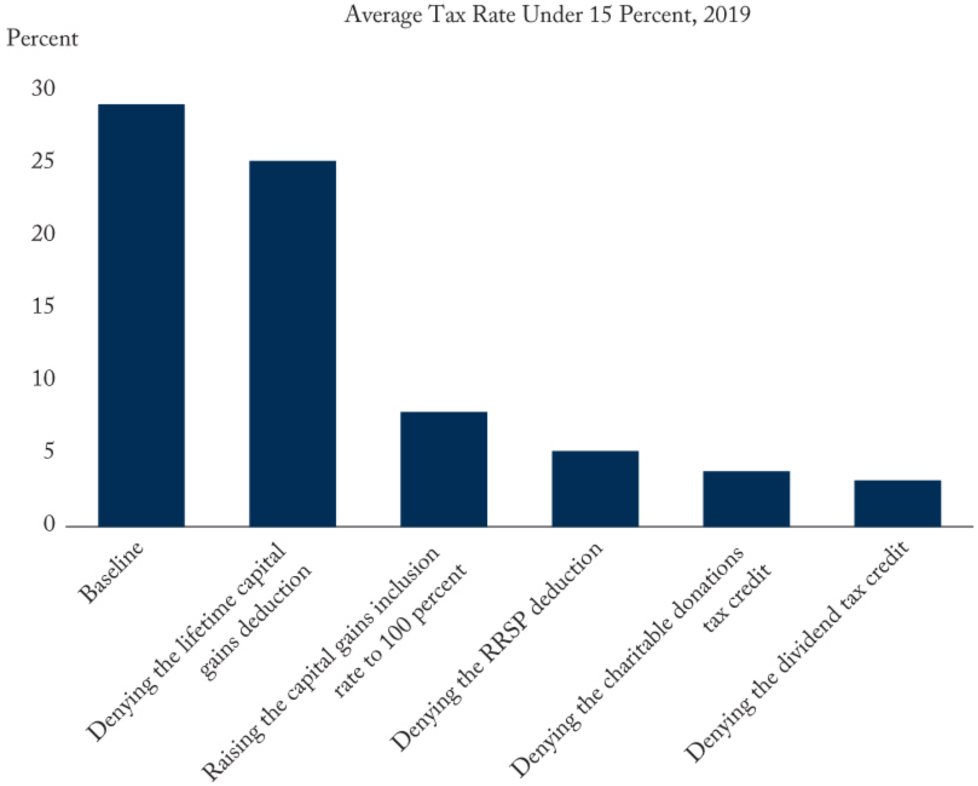
The results in almost 90 percent of these cases seem to be explained by common, and longstanding, income tax provisions. It seems likely, as well, that many of these cases involve individuals encountering major, one-time events: for example, the sale of a farm or small business, or the family cottage; or making a significant RRSP contribution or charitable donation.

The government has provided no signal that it will seek in the upcoming budget to, say, increase the tax burden on capital gains, or to curb RRSP deductions or charitable donations, but if it is wedded to its election platform commitment that "everyone [in] the top bracket pays at least 15 percent each year," there is real cause for concern.

Cumulative Impact of Successively Denying Various Tax Deductions on the Share of High-Income People (gross income over $400K) with an Average Tax Rate Under 15 Percent, 2019



* Results are iterative, i.e., the extent to which a change in one measure will affect average tax rates depends on placement, as taxpayers who would have already been impacted by an earlier measure are disregarded in relation to any other measure.

** Note that this analysis has been based on making the changes described above for regular income tax purposes – for example, by increasing the capital gains inclusion rate from 50 to 100%, and the top effective tax rate on capital gains from 16.5% to 33%. Making these changes only for AMT purposes would not serve to move the under-15 population into the over-15 category without increasing the 15% AMT rate itself (or including/denying for AMT purposes more than 100% of a given item of income/expenditure). We do not suggest that the government will make the radical changes discussed in this note for the sake of addressing its stated concern, but do offer the view that the government will necessarily be increasing the tax burden on, or reducing the tax relief for, on some or all of these items in order to do so.

Source: Authors' calculations using SPSD/M v. 29.0.

Brian Ernewein is Senior Advisor at KPMG in Canada's National Tax Centre, with over 35 years of experience in the Tax Policy Branch of the Department of Finance Canada, Alexandre Laurin is Director of Research at the C.D. Howe Institute, where Nicholas Dahir is a Research Assistant.

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