Explanatory Notes Relating to the Income Tax Act

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Preface

These explanatory notes describe proposed amendments to the *Income Tax Act*. These explanatory notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

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These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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Amendments to the Income Tax Act

Clause 1

Rates for taxation years after 2015

ITA
117(2)

Subsection 117(2) of the *Income Tax Act* (the Act) provides the rates of federal personal income tax. Four amendments are made to this subsection.

First, amounts referenced in this subsection are replaced with their indexed amounts for 2016. These changes are being made so that each dollar amount listed (including the new $200,000 threshold) is for the same year. These amounts will continue to be indexed to inflation. In particular:

- Paragraphs 117(2)(*a*) and (*b*) are amended to replace references to $40,726 with $45,282;
- Paragraphs 117(2)(*b*) and (*c*) are amended to replace references to $81,452 with $90,563; and
- Paragraphs 117(2)(*c*) and (*d*) are amended to replace references to $126,264 with $140,388.

Second, paragraph 117(2)(*b*) is amended to adjust the second rate of personal income tax from 22% to 20.5%.

Third, paragraph 117(2)(*d*) is further amended to limit the application of the third rate of personal income tax to taxable income between $140,388 and $200,000.

Fourth, new paragraph 117(2)(*e*) is added. This new paragraph introduces a new top personal income tax rate of 33%. This new rate will apply to taxable income exceeding $200,000.

These amendments apply to the 2016 and subsequent taxation years.

Clause 2

Deduction by individuals for gifts

ITA
118.1(3)

Section 118.1 of the Act provides a tax credit to individuals for gifts made to registered charities and certain other qualified donees. The amount of the credit is determined under subsection 118.1(3). Currently, the credit is calculated as 15% of the first $200 of such gifts and 29% (i.e., the highest tax rate for individuals) of gifts above that amount. Subsection 118.1(3) is amended, consequential to the introduction of a new top personal income tax rate of 33% in subsection 117(2). In general terms, a new tax credit rate of 33% will apply to gifts in excess of $200 to the extent that an individual has income that is subject to the new 33% income tax rate.

As a result of this amendment, the credit available under subsection 118.1(3) is calculated as the total of

- 15% on the first $200 of total gifts,
- 33% on the lesser of
  - the amount, if any, by which the individual's total gifts for the year exceeds $200, and
  - the amount, if any, by which the individual's taxable income exceeds the dollar threshold for the top personal tax rate (in paragraph 117(2)(*e*)), and
- 29% on the individual's total gifts for the year above $200 that are not eligible for the 33% rate above.

For example, in the case of an individual that has $215,000 of taxable income and makes $20,000 in total gifts in 2016, the individual's tax credit under subsection 118.1(3) is calculated as the total of:

- $30, being 15% of the first $200 of total gifts;
- $4,950, determined as 33% of $15,000, being the lesser of
  - the amount by which the individual's total gifts exceeded $200 ($19,800), and
  - the amount by which the individual's taxable income exceeded $200,000 ($15,000); and
- $1,392, determined as 29% of $4,800, being the amount by which the individual's total gifts for the year ($20,000) exceeds the total of $200 and the amount of the individual's gifts to which the 33% rate applied ($15,000).

In this case, the individual's 2016 tax credit for gifts would total $6,372 ($30 + $4,950 + $1,392).

This amendment will apply to gifts made after 2015. Gifts made in 2015 and previous years, but claimed in 2016 or a later year, will therefore not be eligible for the new 33% tax credit rate.

Clause 3

Definitions

"tax otherwise payable under this Part"

ITA
120(4)

Subparagraph (*b*)(i) of the definition "tax otherwise payable under this Part" in subsection 120(4) of the Act currently refers to 29% of an individual's split income for the year. The "29%" figure is based upon the former top individual income tax rate of 29%, in subsection 117(2).

This subparagraph is amended to reflect the new top personal tax rate of 33% together with the corresponding increase in the tax rate applicable to split income in subsection 120.4(2). The amendment replaces the reference to 29% with a reference to the highest individual percentage (33% for 2016) for the year. For more information, see the commentary under subsection 117(2) and the new definition "highest individual percentage" in subsection 248(1).

This amendment applies to the 2016 and subsequent taxation years.

Clause 4

Tax on split income

ITA
120.4(2)

Subsection 120.4(2) of the Act currently imposes a tax, at the rate of 29%, on an individual's split income for a taxation year. The "29%" figure is based upon the former top individual income tax rate of 29%, in subsection 117(2).

This subsection is amended to reflect the new top personal tax rate of 33%. The amendment replaces the reference to 29% with a reference to the highest individual percentage (33% for 2016) for the year. For more information, see the commentary under subsection 117(2) and the new definition "highest individual percentage" in subsection 248(1).

This amendment applies to the 2016 and subsequent taxation years.

Clause 5

Tax payable by *inter vivos* trust

ITA
122(1)

Section 122 of the Act sets out certain rules that apply in determining the tax payable by a trust (including an estate) under Part I of the Act. Paragraph 122(1)(*a*) generally requires a trust (other than a graduated rate estate or qualified disability trust) to pay tax at a flat rate of 29% on its amount taxable for a taxation year. The "29%" figure is based upon the former top individual income tax rate of 29%, in subsection 117(2).

Paragraph 122(1)(*a*) is amended to reflect the new top personal tax rate of 33%. The amendment replaces the reference to 29% with a reference to the highest individual percentage (33% for 2016) for the year. For more information, see the commentary under subsection 117(2) and the new definition "highest individual percentage" in subsection 248(1).

This amendment applies to the 2016 and subsequent taxation years.

Clause 6

Refundable tax on CCPC's investment income

ITA
123.3

Section 123.3 of the Act imposes an additional amount of tax under Part I of the Act on investment income of a Canadian-controlled private corporation (CCPC). A corporation that is a CCPC throughout a taxation year must add to its tax otherwise payable under Part I for that year an amount that is equal to 6 2/3% of the lesser of two amounts. The first amount is the corporation's "aggregate investment income" for the year as defined in subsection 129(4) and the second is the corporation's taxable income for the year less any amount in respect of which the corporation claimed the "small business deduction" under subsection 125(1). The objective of this additional tax is to reduce personal income tax deferral possibilities that individuals earning investment income directly might otherwise obtain by earning such income through a CCPC.

This section is amended to increase the rate from 6 2/3% to 10 2/3%, consequential to the introduction of a new top personal income tax rate of 33% in subsection 117(2).

This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the rate increase is prorated according to the number of days in the taxation year that are after 2015.

The additional tax imposed under section 123.3 is reflected in a CCPC's "refundable dividend tax on hand" under subsection 129(3). It is accordingly refundable under subsection 129(1) to the corporation when it pays a taxable dividend. For more information, see the commentary under subsections 129(1) and (3).

Clause 7

Private corporations

ITA
129

Section 129 of the Act allows a private corporation that pays a taxable dividend to obtain a partial refund of the tax it has paid on its investment income (a "dividend refund"), subject to certain conditions.

In general terms, the dividend refund mechanism is part of a system in which investment income of a Canadian-controlled private corporation (CCPC) is taxed under Part I of the Act at a rate intended to prevent personal tax deferral on such income, with a portion of the tax paid by the CCPC being refundable upon payment of taxable dividends to its shareholders. This system (including the dividend refund mechanism) also applies to tax paid under Part IV by private corporations on certain taxable dividends that are deductible in computing their taxable income under Part I. Taken as a whole, the system is intended to prevent personal income tax deferral on investment income while providing comparable tax results whether individuals invest directly or through a private corporation.

To preserve the proper operation of this system, section 129 of the Act is amended consequential to the introduction of a new top personal income tax rate of 33% in subsection 117(2).

Dividend refund to private corporation

ITA
129(1)(*a*)(i)

The dividend refund of a private corporation is determined by paragraph 129(1)(*a*) of the Act. The dividend refund is equal to the lesser of 1/3 of all taxable dividends (the "dividend refund rate") paid in the year by the private corporation, and the corporation's refundable dividend tax on hand (RDTOH) at the end of the year.

Subparagraph 129(1)(*a*)(i) is amended to increase the dividend refund rate from 1/3 to 38 1/3%. This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the increase in the dividend refund rate is prorated according to the number of days in the taxation year that are after 2015.

Definition of "refundable dividend tax on hand"

ITA
129(3)(*a*)

The portion of the amount of tax paid by private corporations under Part I or Part IV of the Act that can be refunded to such corporations is determined under the definition "refundable dividend tax on hand" (RDTOH) in subsection 129(3) of the Act. Paragraph 129(3)(*a*) applies where a corporation is a CCPC throughout the year. In computing a corporation's RDTOH under paragraph 129(3)(*a*), an amount in respect of Part I tax is added equal to the least of the amounts described in its subparagraphs (i) to (iii).

Subparagraphs 129(3)(*a*)(i) and (ii) are amended to increase the percentage of investment income of a CCPC that can be included in the corporation's RDTOH and to adjust the amount of foreign investment income that can be included in the corporation's RDTOH.

ITA
129(3)(*a*)(i)

The amount described in subparagraph 129(3)(*a*)(i) generally relates to the CCPC's aggregate investment income for the year. "Aggregate investment income" is defined in subsection 129(4), and includes certain Canadian-source income and foreign-source income. More specifically, the amount under the subparagraph is determined by the formula "A – B", where:

- A is 26 2/3% of the corporation's "aggregate investment income" for the year; and
- B is the amount, if any, by which the amount of the non-business foreign tax credit (FTC) that the corporation deducted with respect to its foreign investment income for the year (subclause (I)) exceeds 9 1/3% of the corporation's foreign investment income for the year (subclause (II)).

The description of A in subparagraph 129(3)(*a*)(i) is amended to increase from 26 2/3% to 30 2/3% the percentage of a CCPC's aggregate investment income for a taxation year included in computing the corporation's RDTOH for the year. This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the rate increase is prorated according to the number of days in the taxation year that are after 2015.

Subclause (II) of the description of B in subparagraph 129(3)(*a*)(i) is amended to adjust the amount of foreign investment income that may be included in computing the corporation's RDTOH.

Foreign-source income may be included in the computation of a corporation's RDTOH at the 26 2/3% rate unless an FTC has reduced the effective Canadian federal tax rate on such income to below 26 2/3%. For this purpose, subparagraph 129(3)(*a*)(i) assumes that foreign investment income is taxed at a Canadian federal tax rate of 36% before any FTC. In general terms, the 36% rate is based on the 28% federal corporate income tax rate (such income being ineligible for the general rate reduction percentage in section 123.4), the additional 6 2/3% tax in section 123.3 as well as the 1.12% corporate surtax formerly applicable under section 123.2 (which was eliminated as of January 1, 2008). Therefore, to limit the amount included in a corporation's RDTOH in respect of its Part I tax, the description of B in the formula in subparagraph 129(3)(*a*)(i) requires a deduction of an amount that is equal to its non-business FTC less 9 1/3% (36 % minus 26 2/3%) of its "foreign investment income".

As a result of the increase in the rate of the additional tax on investment income in section 123.3, the assumed Canadian federal tax rate that applies on foreign investment income (before any FTC) is increased from 36% to 38 2/3%. In general terms, this assumed Canadian tax rate corresponds to the 28% federal corporate tax rate applicable to the aggregate investment income of CCPCs plus the 10 2/3% rate applicable to such income in section 123.3. Accordingly, subclause (II) of the description of B in subparagraph 129(3)(*a*)(i) is amended so that the deduction that is required concerning foreign investment income corresponds to an amount that is equal to the corporation's non-business FTC less 8% (38 2/3% minus 30 2/3%) of its "foreign investment income". This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the reduction in the percentage in the description of B is prorated according to the number of days in the taxation year that are after 2015.

ITA
129(3)(*a*)(ii)

The amount described in subparagraph 129(3)(*a*)(ii) is 26 2/3% of the amount, if any, by which the taxable income of the corporation for the year exceeds the total of the portions of that income that has benefited from either the small business deduction or FTCs. Such portions are determined by grossing-up the amounts claimed as a deduction in subsections 125(1), 126(1) and 126(2).

Subparagraph 129(3)(*a*)(ii) is amended to increase from 26 2/3% to 30 2/3% the percentage of a CCPC's taxable income for a taxation year included in computing the corporation's RDTOH for the year. This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the rate increase is prorated according to the number of days in the taxation year that are after 2015.

Subparagraph 129(3)(*a*)(ii) is also amended to adjust the gross-up factor for foreign non-business income. The current gross-up factor for such income is 100/35, which fraction reflects an assumed Canadian federal corporate income tax of 35%. In general terms, the 35% rate is based on the 28% federal corporate income tax rate (such income being ineligible for the general rate reduction percentage in section 123.4) and the additional 6 2/3% tax in section 123.3. As a result of the increase in the rate of the additional tax on aggregate investment income of CCPCs in section 123.3, the assumed Canadian federal corporate income tax rate on such income becomes 38 2/3%. Therefore, the 100/35 gross-up factor is changed to 100/(38 2/3). This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, the increase in the denominator of the gross-up factor is prorated according to the number of days in the taxation year that are after 2015.

Clause 8

Tax on assessable dividends

ITA
Subsection 186(1)

In general terms, Part IV of the Act imposes a tax on certain taxable dividends received by private corporations that are otherwise deductible in computing their taxable income under Part I (see the definition "assessable dividends" in subsection 186(3)). In concert with the additional tax imposed on the aggregate investment income of a CCPC in section 123.3 and its accompanying dividend refund mechanism in section 129, the Part IV tax is intended to prevent individuals from deferring personal income tax that they would otherwise pay on taxable dividends on shares held as portfolio investments.

The amount of Part IV tax payable by corporations is determined in subsection 186(1) of the Act. Paragraph 186(1)(*a*) provides for the rate of tax payable on assessable dividends received by private and subject corporations from an unconnected dividend payer. The current rate of tax is 33 1/3%, which is intended to approximate the tax that would be paid by individuals at the highest marginal tax rate on taxable dividends. Subparagraphs 186(1)(*c*) and (*d*) provide that the amount under paragraphs (*a*) and (*b*) may be reduced by 33 1/3% of the corporation's unused non-capital losses and farm losses.

Subsection 186(1) is amended to increase the percentage used to determine the tax payable on assessable dividends received from unconnected dividend payers and the unused non-capital loss and farm loss that can reduce Part IV tax.

As is the case under the current rules:

- The amount payable by private corporations and subject corporations on assessable dividends from connected dividend payers determined under paragraph 186(1)(*b*) continues to be calculated by reference to the dividend refund obtained by the corporation that paid the dividends; and
- The full amount of Part IV tax paid by private corporations continues to be fully refundable to the corporations upon payment of taxable dividends to their shareholders, subject to the conditions in section 129.

ITA
Paragraph 186(1)(*a*)

Paragraph 186(1)(*a*) is amended to increase from 33 1/3% to 38 1/3% the rate applicable to assessable dividends received in a taxation year by private corporations or subject corporations from an unconnected dividend payer.

In general terms, the increase in the rate in paragraph 186(1)(*a*) approximates the additional amount of personal income tax that individuals would have to pay on taxable dividends as a result of the new 33% marginal personal income tax rate in subsection 117(2). This additional amount of personal income tax is determined based on a gross-up factor applicable to taxable dividends received by individuals that represents an average of the gross-up factors for eligible and non-eligible dividends that are applicable as of 2019, when the federal small business tax rate will be lowered to 9%.

This amendment applies to taxation years that end after 2015. For such taxation years beginning before 2016, assessable dividends are taxed at 33 1/3% if they are received before 2016, and at 38 1/3% if received after 2015.

ITA
Portion of subsection 186(1) after paragraph 186(1)(*b*) and before paragraph 186(1)(*c*)

The percentage of unused non-capital losses and farm losses that may reduce Part IV tax is also increased from 33 1/3% to 38 1/3%. This amendment applies to taxation years that end after 2015. For such taxation years that begin before 2016, losses applied to reduce Part IV tax are used first to offset assessable dividends that are subject to the higher 38 1/3% rate.

Clause 9

Definitions

ITA

207.01(1)

Subsection 207.01(1) of the Act provides definitions that are relevant for the purposes of taxes under Part XI.01 of the Act, which may apply in respect of Tax-Free Savings Accounts (TFSAs), Registered Retirement Savings Plans and Registered Retirement Income Funds.

"TFSA dollar limit"

The definition "TFSA dollar limit" in subsection 207.01(1) of the Act is relevant primarily for the determination of an individual's "unused TFSA contribution room" and "excess TFSA amount" for a calendar year. When the TFSA was introduced in 2009, the amount of contribution room allocated each year to a qualifying individual was set at $5,000, indexed to inflation and rounded to the nearest $500. Accordingly, an individual's TFSA dollar limit was $5,000 for 2009 to 2012 and $5,500 for 2013 and 2014. Currently, for each year after 2014, an individual's limit is $10,000 without indexation for inflation.

Effective January 1, 2016, the amount of contribution room allocated each year to a qualifying individual will be returned to its original level of $5,000, indexed to inflation for each year after 2009 and rounded to the nearest $500. On this basis, an individual's limit will be $5,500 for 2016 ($5,559 before rounding).

The definition "TFSA dollar limit" is amended in two ways:

- Paragraph (*c*) is amended to reflect the $10,000 limit for 2015.
- New paragraph (*d*) provides that, for each year after 2015, the limit will be the amount determined by indexing $5,000 to inflation for each year after 2009 and rounding the result to the nearest $500.

It is intended that the rules under Part XI.01 relating to excess TFSA amounts and deliberate over-contributions will apply based on a $5,500 limit for 2016.

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

Clause 10

Definitions

ITA
248(1)

“appropriate percentage”

The definition “appropriate percentage” refers to the lowest tax rate referred to in subsection 117(2) of the Act, which is 15% in 2016.

The definition is amended to be consistent with the new definition “highest individual percentage” in subsection 248(1), which refers to the highest tax rate referred to in subsection 117(2). This amendment is intended to ensure consistency between related definitions and is not intended to change the substance of the defined term.

This amendment applies to the 2016 and subsequent taxation years.

“highest individual percentage”

The new definition “highest individual percentage” is added to subsection 248(1) of the Act. This expression means the highest marginal personal tax rate referred to in subsection 117(2), which is 33% in 2016.

This amendment applies to the 2016 and subsequent taxation years.