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Policy Forum: Private Companies, Professionals, and Income Splitting—Recent Canadian Experience

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PRÉCIS

Les médias ont beaucoup traité des politiques fiscales relatives au fractionnement du revenu, en particulier des changements apportés récemment à l'imposition du revenu des particuliers ayant un revenu de pension ou une famille avec enfants. Le fractionnement du revenu est cependant un aspect important de l'imposition des petites entreprises depuis de nombreuses années, même s'il est toujours passé relativement inaperçu. Dans cette étude, nous avons poussé plus loin le travail effectué précédemment par Wolfson, Veall et Brooks sur les effets des sociétés privées sous contrôle canadien (SPCC) sur la distribution globale du revenu, pour établir des estimations empiriques de l'utilisation des SPCC à des fins de fractionnement du revenu. Cette nouvelle étude se fonde sur un couplage unique des données, sous les auspices stricts de la Loi sur les statistiques, des déclarations T2 pour les SPCC, des déclarations T1 de leur propriétaire et des membres de leur famille immédiate, et des feuillets d'information T4 et T5 pertinents. Sur la base de ces données, l'étude actuelle montre que bien que des particuliers de tous les niveaux de revenus possèdent une SPCC, la propriété se concentre en fait dans le groupe des particuliers dont les revenus sont les plus élevés. Sous réserve d'un certain nombre d'avertissements en ce qui a trait aux limites des données, nous estimons ensuite, de façon approximative, et probablement prudente, que le coût budgétaire du fractionnement du revenu au moyen des SPCC s'établit à environ un demi-milliard de dollars annuellement. Enfin, comme autre indication des avantages associés à l'utilisation des SPCC à des fins de fractionnement du revenu, nous repérons le nombre de restaurants, de cabinets d'avocat et de cabinets de médecin qui sont constitués en SPCC. Les tendances observées reflètent une forme d'expérience naturelle, puisqu'il n'y a eu aucun changement important dans les possibilités de fractionnement du revenu pour les restaurants, tandis qu'au cours de la période étudiée, on a pu observer de façon générale un assouplissement de l'approche de l'Agence du revenu du Canada à l'égard du partage de la déduction accordée aux petites entreprises pour les cabinets d'avocat, et un changement facilitant dans le droit des sociétés en Ontario pour les médecins. Bien que les tendances dans le nombre de

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SPCC pour ces deux types de sociétés professionnelles soient des présomptions, elles montrent une corrélation claire avec les tendances dans les traitements juridiques et fiscaux de ces SPCC.

ABSTRACT

Popular media discussions of tax policies with regard to income splitting have focused on recent changes in the individual income tax for those with pension income and families with children. However, income splitting has been an important aspect of small business taxation for many years, even though it has always been relatively obscure. In this study, we have extended earlier work by Wolfson, Veall, and Brooks on the impacts of Canadian-controlled private corporations (CCPCs) on the overall distribution of income, to develop empirical estimates of the use of CCPCs for income splitting. This new study builds on a unique record linkage, under the strict auspices of the Statistics Act, of the T2 returns for CCPCs, the T1s of their owners and these owners' immediate family members, and the relevant T4 and T5 information slips. On the basis of these data, the current study shows that while there are individuals throughout the income spectrum who own CCPCs, ownership is concentrated in upper income groups. Subject to a number of caveats with regard to data limitations, we then provide an approximate, and likely, conservative estimate of the revenue costs of income splitting via CCPCs—about half a billion dollars annually. Finally, as another indication of the benefits of using CCPCs for income-splitting purposes, we track the numbers of restaurants, law practices, and doctors' practices incorporated as CCPCs. The resulting trends reflect a form of natural experiment, since there were no substantive changes in income-splitting opportunities for restaurants, while over the period studied there was a generally more relaxed approach on the part of the Canada Revenue Agency to the sharing of the small business deduction for legal firms, and a specific facilitating change in Ontario corporate law for doctors. While the evidence on the trends in numbers of CCPCs for these two kinds of professional corporations is circumstantial, it shows a clear correlation with trends in the legal and tax treatments of such CCPCs.

KEYWORDS: CORPORATE TAX PLANNING ■ PROFESSIONAL CORPORATIONS ■ INCOME SPLITTING ■ INTEGRATION ■ CCPC ■ TAX EXPENDITURES

CONTENTS

INTRODUCTION

Contemporary income tax policy inevitably must confront two fundamental policy choices: (1) at the individual level, the choice of the tax unit—the individual or a couple; and (2) the relationship between corporate and individual-level income taxation. Generally, these policy choices in income tax design are not discussed together. However, in Canada, tax authorities need to be concerned with the intersection of these two choices since private corporations can be used to reduce individual income taxes[1] via income splitting. This has been a fruitful area for aggressive tax planning, with associated revenue costs and adverse impacts on both horizontal and vertical equity, for decades.

Whether the unit of taxation should be the individual or the couple has long been the subject of debate in the economics of taxation literature. For example, the individual tax unit is less likely to discourage labour market participation of secondary earners, since their marginal tax rate is lower than that of their spouse.[2] In Canada, the longstanding policy has been individual taxation combined with a progressive tax-rate schedule. As a result, for just as long there have been substantial incentives to split incomes with other family members, in order to reduce the rate of tax on that income. For this analysis, we take the individual income tax unit as the benchmark, so income splitting in any form is treated as a "tax expenditure," in line with the federal government's tax expenditure account.[3]

The second policy choice relates to the appropriate tax treatment of income received in a corporation then paid as dividends to an individual owner of shares in that corporation. This income first bears tax as it is received by the corporation under the corporate income tax, and then may be taxed again in the hands of individual share owners when they receive dividends. To the extent that this occurs, it is widely considered to constitute "double taxation," or "underintegration" of the individual and corporate income tax systems. There is a long history in Canadian tax policy of treating dividends in a special way to reduce, if not eliminate, such underintegration. Technically, a special set of calculations—the dividend gross-up and tax credit among others—is required to approximate corporate income tax integration.[4]

The current political debates over these policy choices are being carried out in isolation, and are failing to account for the interactions between these choices.

To illustrate the issues that can arise, consider a university student in Ontario with no income. This student could receive over $40,000 per year in dividends from a Canadian-controlled private corporation (CCPC) owned by his or her parents and

1 We eschew use of the term "personal tax" because in law, corporations are persons.

2 See Patricia F. Apps and Ray Rees, "On the Taxation of Trade Within and Between Households" (1999) 73:2 *Journal of Public Economics* 241-63; and Jonathan R. Kesselman, "Income Splitting and Joint Taxation of Couples" (2008) 14:1 *IRPP Choices* (Institute for Research on Public Policy).

3 See Canada, Department of Finance, *Tax Expenditures and Evaluations 2013* (Ottawa: Department of Finance, 2014) for the most recent estimates; and Canada, Department of Finance, *Tax Expenditures: Notes to the Estimates/Projections 2010* (Ottawa: Department of Finance, 2010) for a description of the benchmark tax system.

4 It is also possible to have overintegration when the dividend gross-up and tax credit compensate individual dividend recipients for more corporate income tax than was actually paid by the corporation.

pay no individual income tax at all.[5] Inside the private company that paid the dividends to the student, if the dividends came from income that was taxed at the lower small business rate, that income would have been taxed at about 15 percent (depending on the province where the income was earned).[6] As a result, income that might have been taxed at the top marginal income tax rate of 45 to 50 percent in the hands of one of the parents can end up being taxed at a combined corporate plus individual income tax rate as low as 15 percent.

To the extent that families can arrange their affairs in this way, de facto income splitting can occur. Income for tax purposes is moved from the hands of a family member in a higher income tax bracket to another family member in a lower (or zero) tax bracket.

The purpose of this study is to make the connection between recent high-profile debates about the appropriate tax unit, and the separate political promises and legislation regarding the special low tax rate on incorporated small business income. By bringing these completely separate discussions together, we highlight the revenue costs to tax authorities and, more broadly, serious horizontal and vertical equity issues.

This study is one step in a larger project. The data on which it is based have never before (to our knowledge) been used at this level of detail.[7] Coming as they do from various aspects of the administration of Canada's income tax system, the data were not designed for the kind of analysis presented. Hence, there are a number of limitations in this analysis, which will be addressed in subsequent components of the project. Still, the data are of sufficient quality, and the questions being addressed of sufficient importance, that valuable insights have been obtained.

The discussion that follows is divided into two main sections. We focus first on the use of CCPCs for income splitting. We then examine data on professionals, specifically doctors and lawyers, where the low small business rate and income-splitting opportunities have apparently provided important tax-planning benefits.

Rationales for the low small business tax rate include providing incentives for job creation and compensating for difficulties accessing capital markets.[8] And it is likely

5 John Heinzl, "You Do the Math: Almost $50,000 in Earned Dividends, $0 in Tax," *Globe and Mail*, October 9, 2012. Maximum no-tax thresholds vary by province.

6 For an Ontario-resident corporation, the federal rate is 11 percent and Ontario rate is 4.5 percent. See Canada Revenue Agency, "Corporation Tax Rates" (www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rts-eng.html).

7 The data used are held by Statistics Canada and have been produced under contract by full-time Statistics Canada staff. Neither of the authors has had direct access to the raw data, and all the work has been conducted under the very strict auspices and protections of the Statistics Act.

8 For discussion of benefits and drawbacks of special tax rates for small business, see Claire Crawford and Judith Freedman, "Small Business Taxation," in James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, eds., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: Oxford University Press, 2010), 1028-99, especially section 11.6. They conclude that at best, the rationale is weak for across-the-board preferential tax treatment of small business. Also see

that these incentives are reasonable for a significant number of small businesses. However, these arguments seem hard to apply to the professional practices of doctors and lawyers.

DATA AND METHODS

This analysis builds on the initial results reported in Wolfson et al.[9] That study showed that income received and retained within a CCPC was highly skewed toward the rich, and failing to include it in the usual income inequality statistics caused an important understatement of the incomes of the top 1 percent in Canada. In terms of after-tax income, the share of the top 1 percent in 2010 increased by one-third, from 10 percent to 13.3 percent, when income retained within their CCPCs was added.

That initial analysis relied on a linkage, under the stringent confidentiality protection provisions of the Statistics Act, between the corporate income tax returns of CCPCs and the individual income tax returns of their owners. Building on this earlier work, and using data for the 2011 taxation year, we have further linked the T4 and T5 tax information slips—for wages and salaries and for dividend income, respectively—to the CCPCs that issued them, and to the individual tax filers who received these incomes; and in the case of T4s, we have linked the data to flag whether or not the recipients were owners of (held any shares in) a CCPC. This linkage of T4 and T5 tax slips to both their originating CCPCs and their individual recipients is key to estimating, for the first time in Canada, the use and value of CCPCs for income splitting.[10]

INCOME SPLITTING VIA CCPCs

Income splitting has been headline news in Canada recently, with the provision for splitting of pension income for the 2007 tax year, and the family tax cut provision for family income splitting starting in 2014. However, below the radar of the popular media, income splitting via private companies has been possible for decades. The Department of Finance and the Canada Revenue Agency (CRA) have been playing cat and mouse with aggressive tax planners at least since the 1970s. Indeed, through the 1990s, flowing dividends from CCPCs to minor children became viewed as so

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Duanjie Chen and Jack M. Mintz, "Small Business Taxation: Revamping Incentives To Encourage Growth" (2011) 4:7 *SPP Research Papers* 1-29 (University of Calgary, School of Public Policy).

9 Michael Wolfson, Mike Veall, and Neil Brooks, "Piercing the Veil: Private Corporations and the Income of the Affluent," 2014 (https://uwaterloo.ca/school-of-accounting-and-finance/sites/ca.school-of-accounting-and-finance/files/uploads/files/wolfson-brooks-veall_-_incomes_of_affluent.pdf).

10 This analysis is not the first of its kind in Canada. The only other, in our experience, was a microdata file to which Wolfson had access as an analyst in the Tax Policy Branch of the Department of Finance in the late 1970s. However, to our knowledge, this is the first such analysis with publicly available results.

abusive that the 1999 federal budget introduced a "kiddie tax" to prevent such behaviour. As stated in the detailed technical portion of the budget,

> [p]rogressivity of tax rates is one of the principles of the Canadian personal income tax system. High-income individuals are considered to be better able to bear a higher rate of income taxation than are lower-income individuals. This progressivity is reflected in the three different federal marginal tax rates. . . . Currently, the income tax system uses attribution rules to reduce the opportunities for income splitting. These rules apply in certain cases to attribute to a taxpayer income from property that has been provided directly, or indirectly (for example, through a trust or corporation), to an individual by the taxpayer. Generally these rules apply in the family context. However, several tax planning techniques have developed over time to avoid the application of the attribution rules or to take undue advantage of exceptions provided in those rules. In addition, recent case law has provided support for income-splitting techniques contrary to policy intent. In order to improve the fairness and integrity of the Canadian tax system, this budget proposes a targeted measure to discourage income splitting with minor children. The new measure constitutes a special tax, at the top marginal tax rate instead of the normal graduated rates, to be imposed on certain income of individuals age 17 or under.[11]

Interestingly, in table A7-1 of the same budget document, the revenue impact of this new anti-avoidance measure is shown at zero because it is "[s]mall, non-existent or prevents revenue loss."[12] In contrast, a recent study estimated revenue losses upward of $200 million annually.[13] And as recently as the 2014 federal budget, further technical amendments were included to strengthen the kiddie tax.[14]

In this section, we explore the extent of income splitting using the unprecedented data from the linkage of information from CCPC corporate income tax returns to individual income tax returns. These individual returns include not only those of the CCPC share owners, and any T5 dividend income received from the CCPC, but also the returns of any family members who received T4 wage and salary income from such CCPCs whether or not they owned any shares.

It should be emphasized that there are important caveats to this analysis. "Families" in this analysis refers to related individuals—parents and their children—living at the same address. As a result, children (and grandchildren) no longer living at

11 Canada, Department of Finance, 1999 Budget, Budget Plan, February 16, 1999, at 193.

12 Ibid., at 178, note to table A7-1.

13 See Andrew M. Bauer, Alan Macnaughton, and Anindya Sen, "Income Splitting and Anti-Avoidance Legislation: Evidence from the Canadian 'Kiddie Tax'" (2014) *International Tax and Public Finance* 1-36 (http://link.springer.com/article/10.1007/s10797-014-9342-z?no-access=true). For an earlier study, see Alan Macnaughton and Thomas Matthews, "Is the Income-Splitting Tax Needed? Some Empirical Evidence" (1999) 47:5 *Canadian Tax Journal* 1164-79.

14 See Andrew Stirling, "Revisions to the Tax on Split Income (the Kiddie Tax)," *McMillan Budget 2014 Bulletin*, February 2014, 1-4 (www.mcmillan.ca/Files/170302_Revisions%20to%20the%20Tax%20on%20Split%20Income.pdf).

home are not included, even though they may be parties to income splitting within a family.

In the tax-planning literature, frequent reference is made to the use of family trusts as a useful mechanism. However, incomes flowing via trusts to family members have not been included.

We have also focused only on directly owned CCPCs; CCPCs owned indirectly through another CCPC have been ignored.

These omissions likely understate the extent of income splitting estimated below.

A key tax-planning tool available to controlling CCPC owners is "dividend sprinkling," where the controlling owner can issue different classes of shares to different individuals. In this way, the controlling CCPC owner can declare one dividend on one class of shares and some other dividend on another class of shares. This gives the owner the discretion to direct dividend payouts to family members in a way that minimizes tax, and in amounts that can vary flexibly from year to year as these individuals' income positions evolve over time.

The key corporate income tax form, the T2S50, provides the data used to link each CCPC's business number to individual shareholders' social insurance numbers. However, this form does not include any requirement to list owners of less than 10 percent of the outstanding common or preferred shares, nor does it require any information on whether shares are voting or non-voting, or whether they are of different classes.[15] As a result, our analysis of income splitting must rely on a number of simplifying assumptions.

Table 1 provides a range of detailed figures arranged by individuals' total income decile (based on their T1 returns, excluding capital gains) on the numbers of CCPC owners and their family members, and the dollar amounts at play in terms of wages and salaries recorded in T4 slips, and dividend income recorded in T5 slips, for the 2011 taxation year.

With the data we have, there is no direct way to identify the controlling owner of each CCPC. As a result, we have developed a rule of thumb to identify an assumed "controlling owner" for all of the directly owned CCPCs in each family. If the "family" is an unattached individual, that person is assumed to be the controlling owner; it is also assumed that there is no income splitting. If the family has two or more members and children are present, the controlling owner is assumed to be the parent or, if two parents are present, the parent with the higher income.

Interestingly, according to the data in table 1, in 2011 58 percent of all 1.677 million CCPC owners took no income from their CCPC as T4 wage and salary income (1,677,000 − 711,000 = 966,000 tax-filing CCPC owners) and 71 percent took no

15 In the spirit of the 2015 spring report of the auditor general of Canada (for example, paragraphs 3.47, 3.48, and 3.77), if the Department of Finance were serious about having the capacity to evaluate this important tax expenditure, it would require the CRA to collect such information routinely. See Auditor General of Canada, *Spring 2015 Reports of the Auditor General of Canada* (Ottawa: Office of the Auditor General of Canada, 2015).

TABLE 1 Selected Statistics for Income Tax Filers and Owners of Canadian-Controlled Private Corporations (CCPCs) and Their Family Members by Income Decile, 2011

		Income decile[a]										
		1	2	3	4	5	6	7	8	9	10	Total (all deciles)[b]
1	No. of tax filers	2,605.0	2,605.0	2,605.0	2,604.0	2,605.0	2,605.0	2,605.0	2,605.0	2,605.0	2,605.0	26,049.0
2	No. of CCPC owners	77.0	66.0	88.0	97.0	128.0	154.0	173.0	203.0	239.0	453.0	1,677.0
3	No. of CCPC owners with T4 income from a CCPC they own	7.0	16.0	31.0	39.0	57.0	73.0	81.0	95.0	110.0	203.0	711.0
4	No. of CCPC owners with T5 dividend income from a CCPC they own	4.0	4.0	7.0	12.0	23.0	40.0	53.0	69.0	85.0	184.0	480.0
5	CCPC owners as a percent of all tax filers (row 2/row 1)	3.0	2.5	3.4	3.7	4.9	5.9	6.7	7.8	9.2	17.4	6.4
6	CCPC owners receiving T4 income as a percent of all CCPC owners	9.1	24.4	35.4	40.1	44.7	47.4	46.7	46.8	46.0	44.9	42.4
7	CCPC owners receiving T5 income as a percent of all CCPC owners	5.2	6.1	8.0	12.3	18.0	26.0	30.6	34.0	35.6	40.7	28.6
8	Total income, all filers	4,549.0	23,663.0	37,909.0	51,048.0	67,302.0	87,391.0	110,031.0	139,334.0	185,062.0	383,452.0	1,089,741.0
9	Total T4 income, all filers	2,132.0	7,672.0	11,866.0	17,385.0	32,305.0	51,150.0	73,161.0	100,875.0	147,271.0	286,637.0	730,454.0
10	Total T4 income, all CCPC owners	76.0	193.0	493.0	819.0	1,607.0	2,714.0	4,019.0	6,266.0	10,572.0	55,378.0	82,136.0
11	Total T4 income from family CCPC(s) received by CCPC "controlling owners"[c]	13.0	27.0	111.0	235.0	536.0	951.0	1,452.0	2,401.0	4,038.0	21,656.0	31,421.0

(Table 1 is continued on the next page.)

TABLE 1 Continued

		Income decile[a]									
		1	2	3	4	5	6	7	8	9	10	Total (all deciles)[b]
12	Total T4 income from family CCPC(s) received by all other family members	44.0	128.0	275.0	394.0	657.0	963.0	1,173.0	1,452.0	1,738.0	3,728.0	10,553.0
13	Total T5 dividend income, all filers	103.0	163.0	277.0	486.0	962.0	1,699.0	2,444.0	3,539.0	4,964.0	27,138.0	41,776.0
14	Total T5 dividend income, all CCPC owners	36.0	37.0	77.0	174.0	431.0	942.0	1,475.0	2,220.0	3,261.0	21,370.0	30,023.0
15	Total T5 dividend income from family CCPC(s) received by CCPC "controlling owners"[c]	23.0	9.0	16.0	45.0	129.0	346.0	632.0	1,099.0	1,758.0	14,307.0	18,365.0
16	Total T5 dividend income from family CCPC(s) received by all other family members	41.0	29.0	42.0	85.0	208.0	432.0	618.0	810.0	1,031.0	2,853.0	6,149.0
17	Percent of all CCPC owners	4.6	3.9	5.2	5.8	7.6	9.2	10.3	12.1	14.3	27.0	100.0
18	Percent of all CCPC owners with a T4 from a CCPC they own	1.0	2.3	4.4	5.5	8.0	10.3	11.4	13.4	15.5	28.6	100.0
19	Percent of all CCPC owners with dividends on a T5 from a CCPC they own	0.8	0.8	1.5	2.5	4.8	8.3	11.0	14.4	17.7	38.3	100.0
20	Percent of total income, all filers	0.4	2.2	3.5	4.7	6.2	8.0	10.1	12.8	17.0	35.2	100.0
21	Percent of total T4 income, all filers	0.3	1.1	1.6	2.4	4.4	7.0	10.0	13.8	20.2	39.2	100.0

(Table 1 is continued on the next page.)

TABLE 1 Continued

		Income decile[a]									
		1	2	3	4	5	6	7	8	9	10	Total (all deciles)[b]
22	Percent of total T4 income, all CCPC owners	0.1	0.2	0.6	1.0	2.0	3.3	4.9	7.6	12.9	67.4	100.0
23	Percent of total T4 income from CCPC(s), all CCPC "controlling owners"	0.0	0.1	0.4	0.7	1.7	3.0	4.6	7.6	12.9	68.9	100.0
24	Percent of total T4 income of family members of a CCPC owner from CCPC(s)	0.4	1.2	2.6	3.7	6.2	9.1	11.1	13.8	16.5	35.3	100.0
25	Percent of total T5 dividend income, all filers	0.2	0.4	0.7	1.2	2.3	4.1	5.9	8.5	11.9	65.0	100.0
26	Percent of total T5 dividend income, all CCPC owners	0.1	0.1	0.3	0.6	1.4	3.1	4.9	7.4	10.9	71.2	100.0
27	Percent of total T5 dividend income from CCPC(s), all CCPC "controlling owners"	0.1	0.0	0.1	0.2	0.7	1.9	3.4	6.0	9.6	77.9	100.0
28	Percent of total T5 dividend income of family members of a CCPC owner from CCPC(s)	0.7	0.5	0.7	1.4	3.4	7.0	10.1	13.2	16.8	46.4	100.0
29	Wages (T4 income) as a percent of total income (row 9/row 8)	46.9	32.4	31.3	34.1	48.0	58.5	66.5	72.4	79.6	74.8	67.0
30	Dividends as a percent of total income (row 13/row 8)	2.3	0.7	0.7	1.0	1.4	1.9	2.2	2.5	2.7	7.1	3.8

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

		Income decile[a]									
		1	2	3	4	5	6	7	8	9	10	Total (all deciles)[b]
31	CCPC wages of CCPC "controlling owners"[c] and their families as a percent of all wages of CCPC owners [(row 11 + row 12)/row 10]	75.3	80.1	78.4	76.8	74.3	70.5	65.3	61.5	54.6	45.8	51.1
32	CCPC dividends of CCPC "controlling owners"[c] and their families as a percent of all dividends of CCPC owners [(row 15 + row 16)/row 14]	179.0	102.0	75.3	74.6	78.1	82.6	84.8	86.0	85.6	80.3	81.7
33	CCPC family wages as a percent of "controlling owner"[c] wages (row 12/row 11)	347.0	481.5	248.5	167.7	122.5	101.2	80.8	60.5	43.0	17.2	33.6
34	CCPC family dividends as a percent of "controlling owner"[c] dividends (row 16/row 15)	180.6	329.7	255.7	190.2	160.7	124.8	97.8	73.7	58.7	19.9	33.5

Notes: Whole numbers other than income or earning represent thousands; income and earnings amounts represent millions of dollars.

[a] Total income for the year.

[b] Totals may be different from the sum of all deciles because of rounding.

[c] "Controlling owner" is defined as follows: for an unattached individual, that person; for a family with two or more members, the parent or, if two parents were present, the one with the higher income.

T5 dividend income (1,677,000 − 480,000 = 1,197,000); 42 percent took neither T4 nor T5 income (not shown in the table). These figures suggest that (1) their CCPCs were not making much money; (2) profits were being reinvested as the policy intends to support entrepreneurship and economic growth; or (3) whatever money they were making was being retained within the CCPC and thereby benefiting from substantial tax deferral. (In future analysis, we plan to develop further data to distinguish among these possibilities.)

As shown in table 1, T4 wage and salary income in the economy overall amounted to $730 billion in 2011 (row 9, last column). CCPC owners received $82 billion from employment, whether in their owned CCPCs or not (row 10, last column). Of this amount, just over half ($42 billion = $31.4 + $10.6) (rows 11 + 12, last column) was paid to the owners or to their immediate family members from a CCPC they or a family member owned. Correspondingly, about $42 billion in dividend income was reported by all individual income tax filers in 2011 (row 13). Of this, almost three-quarters ($30 billion) was received by CCPC owners (row 14), almost $25 billion of which came from their (directly owned) CCPCs (rows 15 + 16).

Focusing on the last two rows of table 1, for every dollar of both wage and salary income and dividend income received by CCPC "controlling owners," about 33 cents was paid to immediate family members of such owners. However, these figures vary dramatically by income decile. This is not surprising since the basic objective of income splitting is to move income from family members with higher income to those with lower income, who hence face a lower or even zero marginal rate of income tax. For example, in the eighth decile, for every dollar of T4 and T5 income received by such owners, 60.5 cents and 73.7 cents, respectively, was received by family members in the same decile (not necessarily the same family), while in the third decile, the corresponding amounts were about 250 cents.

Of course, not all of this money paid to family members is for income-splitting purposes. Still, given the amounts in table 1, it is possible to generate some very rough estimates of the revenue costs of income splitting through the use of CCPCs. We can consider two sets of assumptions. One concerns the amounts of T4 wage and salary income and T5 dividend income paid to family members of CCPC owners solely for the purpose of reducing income tax payable, especially via income splitting. The other is the difference in effective tax rates between the individual doing the income splitting—in principle, the deemed controlling owner of the CCPC(s)—and the family members receiving the income instead.

For the first set of assumptions, it is reasonable to consider all T5 dividend income in the hands of other family members as income received for the purposes of reducing taxes payable. A substantial portion of such dividends is almost certainly for income splitting. But if both spouses of a couple provide similar effort working in a family business, payment of dividends could instead be a reflection of the practice of structuring remuneration in the most "tax-efficient" manner as a mixture of dividends and salary (for example, paying some salary to enable registered retirement savings plan contributions, and some dividends to benefit from the lower combined corporate plus individual tax rate on dividends, and to reduce payroll taxes).

In the case of T4 income, legally all such income must comprise legitimate payments in respect of work actually performed and remunerated at a fair market wage rate; anything else amounts to tax evasion. However, there is a general sense that such salaries are often overstated in order to benefit from income splitting. Unfortunately, there are no readily available administrative data to support an estimate of the proportion of T4 payments that are bona fide.[16] In a recent newspaper article providing tax advice on this question, an example is given where a 50 percent premium on the going (median) wage rate should be acceptable to the CRA.[17] We have therefore posited, as a sensitivity analysis, that either 10 percent, 30 percent, or 50 percent of this T4 income is paid for the purposes of splitting; in other words, the amount paid is in excess of fair market remuneration for work actually performed.

The second set of assumptions relates to the difference in the effective marginal tax rate on income in the hands of the controlling owner of the CCPC and the corresponding marginal tax rates of the owner's family members. From a tax-planning perspective, it is unlikely that an individual would undertake the administrative burden of establishing a CCPC in the first place if the tax-planning advantage were less than 5 percentage points, and it is possible that in many cases, this tax-rate difference is at least 10 or 15 percentage points.[18]

To illustrate these effects, table 2, drawing on the results in table 1, shows what the aggregate income tax savings would be for CCPC owners in 2011 (and hence lost tax revenues), depending on which of these pairs of assumptions is made. For example, if we assume that a 5 percentage point difference between the effective marginal tax rate of the individual who would otherwise have received the income and that of the individual who actually received the income, and we further assume that 30 percent of T4 income paid was for income-splitting purposes, the aggregate revenue cost would have been almost half a billion dollars in 2011. Alternatively, if a lesser amount of T4 income were used for income splitting—say, 10 percent—but

16 See Herbert J. Schuetze, "Income Splitting Among the Self-Employed" (2006) 39:4 *Canadian Journal of Economics* 1195-1220. Using survey data from Canada and the United States, the author estimates that $500 million in taxes was avoided by incorporated and unincorporated self-employed individuals by paying excessive wage income to spouses.

17 "Small business owners who employ family members for income-sharing purposes need to pay a reasonable salary, and be able to show the paperwork behind the pay. But what's *reasonable*? . . . Unfortunately, the CRA doesn't have a hard and fast rule for what's deemed an acceptable salary. But if you pay the family member what you would pay a typical employee, the CRA would have little reason to discount the deduction. To determine a realistic wage isn't difficult, though. Career websites list average wages for jobs in numerous industries. According to the federal government's Job Bank site, the median hourly wage for an office clerk is $18 an hour, for instance, although the site indicates you could go as high as $28 and still be in the right ballpark." Kira Vermond, "One Way To Reduce Small-Business Taxes: Income-Splitting," *Globe and Mail*, Monday, May 4, 2015 (www.theglobeandmail.com/report-on-business/small-business/sb-tools/one-way-to-reduce-small-business-taxes-income-splitting/article24207847/).

18 Of course there are other reasons to incorporate a business, such as limited liability.

TABLE 2 Implied Revenue Costs of Income Splitting via CCPCs Under Various Assumptions, 2011

	Percentage points of difference in effective marginal tax rates			
Percentage of wages included	1	5	10	15
	$ millions			
10	72	360	720	1,081
30	93	466	932	1,379
50	114	571	1,143	1,714

CCPCs = Canadian-controlled private corporations.

the effective marginal tax rate difference were higher, at 10 percentage points, then the tax benefit would be worth substantially more than half a billion dollars.

To provide points of comparison, the family tax cut introduced in the March 2015 federal budget is estimated to reduce federal income taxes by $1.9 billion in 2015-16,[19] and the pension income-splitting provision introduced in the 2006 federal budget is estimated to cost $1.1 billion in 2014.[20] The family tax cut has been structured so that provincial income tax revenues are not affected. But pension income splitting induces a further $500 million in provincial revenue costs. The Office of the Parliamentary Budget Officer[21] and the Canadian Centre for Policy Alternatives[22] both estimate somewhat higher revenue costs for the family tax cut.

It therefore appears that the 2011 revenue costs of income splitting via CCPCs are not as large as the revenue costs for the family tax cut income splitting and pension income splitting. Further analysis is required, however, to determine the extent to which these tax benefits are skewed toward individuals with higher incomes.

INCORPORATION OF PROFESSIONALS

The very idea that professionals such as doctors have been able to receive income indirectly through a privately owned company is fairly recent. In *Kindree*, the Exchequer Court had

> no doubt whatsoever that the practice of medicine can only be carried on by a natural person involving a personal responsibility to the patient and to the governing body of

19 Canada, Department of Finance, 2015 Budget, Budget Plan, April 21, 2015, at 227 and 261. For more detail, see Canada, Department of Finance, "Helping Families Prosper," Backgrounder to *News Release*, October 30, 2014.

20 Canada, Department of Finance, *Tax Expenditures and Evaluations 2014* (Ottawa: Department of Finance, 2015), table 1, at 18.

21 Tim Scholz and Trevor Shaw, *The Family Tax Cut* (Ottawa: Office of the Parliamentary Budget Officer, 2015), at 1.

22 See David Macdonald, *Income Splitting in Canada: Inequality by Design* (Ottawa: Canadian Centre for Policy Alternatives, 2014).

> the profession, such conclusion being obvious from the general tenor of the *Medical Act* and the code of ethics of the medical profession to which the appellant subscribed.[23]

However, the *Campbell* decision[24] held that if (provincial) legislation allowed professionals to incorporate, the federal tax authorities had to recognize these structures. The federal government reacted by amending the Income Tax Act in 1979 to disallow by another means the preferential small business tax rate for professional corporations carrying on the practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor—thereby removing one of the major incentives for incorporation.[25]

However, as one commentator has observed, "it appears that the Canada Revenue Agency . . . no longer views the use of a professional corporation as an unduly aggressive tax avoidance scheme,"[26] though the writer goes on to state:

> In a letter written by a senior Revenue Canada official to the Chief of Avoidance Services, Head Office (in the early 1990s), (while) lobbying for aggressively challenging professional corporations, the use of family trusts with professional corporations was described as follows: "Our view is that these arrangements are extremely offensive. In fact, this is arguably the most abusive scheme which I have ever seen."[27]

These concerns about incorporated professionals have apparently not only abated in the years since, but further given way to the CRA's providing advance rulings that go in the opposite direction by enlarging access to preferential tax treatment for some professions (see below).

Notwithstanding the role of the Act, much of the legislation governing the ability of professionals to receive their income through a private company is generally a matter of provincial jurisdiction. The rules vary from one province to another, and from one profession to another.

One major benefit of receiving professional income via a private corporation is tax deferral, especially to the extent that the income received qualifies for the small business deduction. In Ontario in 2015, for example, such income is taxed within the CCPC at a combined federal-provincial rate of about 15 percent.[28] This rate is far lower than the top marginal federal plus provincial individual income tax rates, which are in the 45 to 50 percent range.

23 *Kindree v. MNR*, 64 DTC 5248, at 5251 (Ex. Ct.).

24 *The Queen v. Campbell*, 80 DTC 6239 (SCC).

25 Income Tax Act, SC 1970-71-72, c. 63, as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

26 David G. Thompson, "Professional Corporations," in *2005 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2005), 14:1-81, at 2.

27 Ibid.

28 See supra note 6.

In principle, any income preferentially taxed and retained in the CCPC will eventually end up being subject to individual income tax when it is paid out to the owner. But the income-splitting opportunities described in the previous section mean that such income can be paid out to others in the professional's family[29] who may be non-taxable or in lower income tax brackets—either as dividends or as employment income.

Perhaps the most dramatic indication of the value of receiving income via a CCPC and then using the income-splitting possibilities is the 2005 Ontario budget, and the obscure change that it made for doctors and dentists. The text in the budget may have looked innocuous:

> In 2001, the right to incorporate was extended to all regulated professionals. Under existing provisions, non-members of a profession cannot own shares in a professional corporation. Recent negotiations with the Ontario Medical Association have resulted in the government's commitment to extend the share structure of physician professional corporations to include non-voting shares for family members. The government is also proposing to implement this change for dentists who operate their practices through a professional corporation.[30]

As this text states, the legislative change was made in the context of fee negotiations with doctors, so it is likely that both sides would have known that this technical change would provide a non-trivial monetary benefit for members of the Ontario Medical Association (OMA).[31]

In order to provide an empirical basis for informing discussion of the importance of income splitting, we draw on data on the numbers of CCPCs over time, from 2001 to 2011, across provinces, and across industries. If the time trends in the numbers of CCPCs are relatively flat for all industries and all provinces, then it is unlikely that changes specific to lawyers and doctors have had any material effect.

As the first step, figure 1 shows trends in the numbers of CCPC owners whose primary CCPC's industry code was a restaurant.[32] Only data for the four largest provinces are shown to maintain data confidentiality. In this case, where there were no

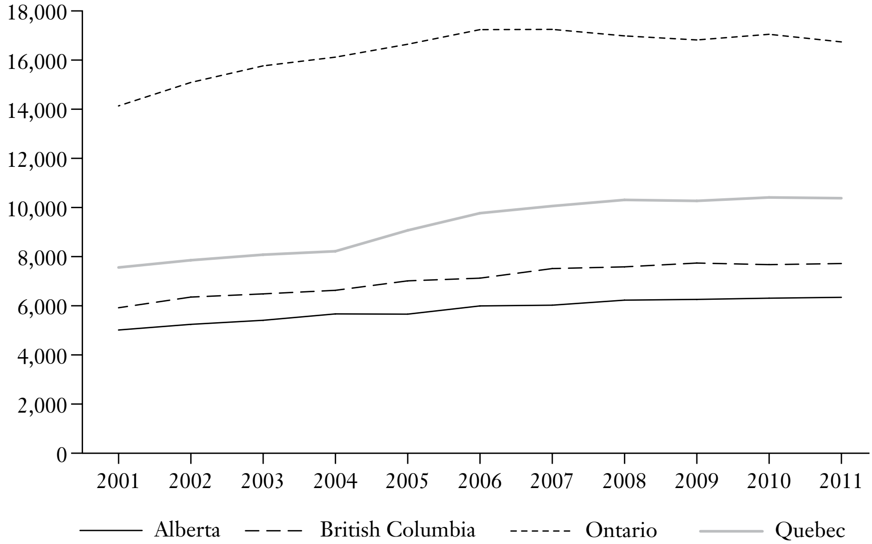
29 The ease with which dividends can be paid to family varies by profession. For physicians and dentists in Ontario, it is relatively simple (see the text accompanying note 30 below); for professionals such as lawyers, more planning is required.

30 Ontario, Ministry of Finance, 2005 Budget, Paper C, Details of Revenue Measures, May 11, 2005, at 159.

31 Interestingly, this legislative change by Ontario represents one of the few occasions where a provincial initiative costs the province only about one-third of the benefit provided to physicians and dentists: the Ontario revenue cost is automatically matched by federal individual income tax revenue costs, since federal effective marginal tax rates are approximately twice those for Ontario. In more technical terms, the result is a negative vertical fiscal externality on the federal government.

32 "Primary" refers to the CCPC with the greatest net retained earnings in the tax year where the owner owns multiple CCPCs; 85 percent of owners in our sample owned only one CCPC.

FIGURE 1 Trends in the Number of Restaurant CCPCs in the Four Largest Provinces, 2001-2011



CCPC = Canadian-controlled private corporation.

major changes over time or across provinces, the trend number of CCPCs is relatively flat.

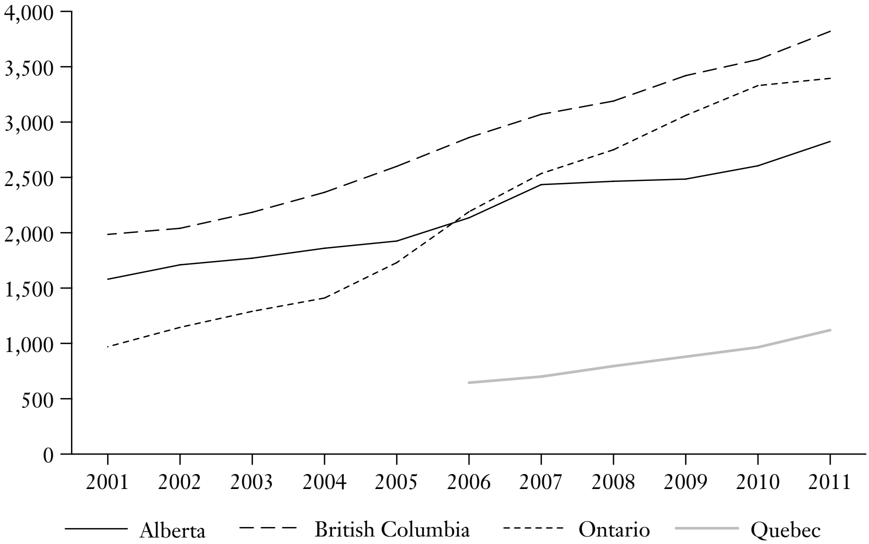
Figure 2 shows the corresponding trends for lawyers (owners of legal practices incorporated as CCPCs), and figure 3 for doctors (owners of offices of physicians incorporated as CCPCs).[33] (Note that the vertical axis scales for restaurants, and physicians are identical, while that for lawyers is less than one-quarter the magnitude.)

Lawyer CCPCs show a substantially faster rate of growth than restaurant CCPCs. However, there has been an important change in the tax treatment of lawyers, as compared with restaurants. This is the increased granting by the CRA of advance rulings that allow law partnerships to restructure themselves as combinations of a single central service company combined with a series of CCPCs each owned and used by one lawyer individually.[34]

33 Unfortunately, it is not possible to identify doctors or lawyers by their occupation in the tax data being used. Instead, the best we can do is use the NAICS (North American Industrial Classification System) code for tax filers' CCPCs.

34 We have had access to an anonymized specimen of such a ruling, as well as private communications.

FIGURE 2 Trends in the Number of Lawyer CCPCs in the Four Largest Provinces, 2001-2011



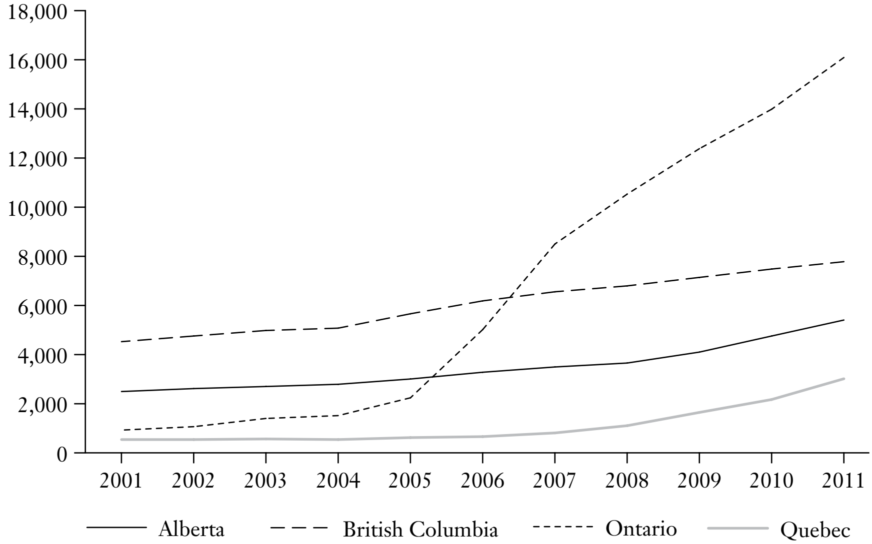
CCPC = Canadian-controlled private corporation.

One of the major tax-planning advantages of this kind of restructuring is that instead of all the lawyers in a practice having to share a single small business deduction amount ($500,000), each lawyer can have his or her own. So in a practice with 20 lawyers, instead of each lawyer being able to receive $25,000 taxed at the low small business tax rate, they can each receive income of up to $500,000 per year and have it taxed at the low rate. Further, while non-professional family members are not permitted to own shares directly in a lawyer's CCPC, they may be able to own shares in a related CCPC—for example, one providing other services to the law practice. Since the relevant regulatory change was Canada-wide, at the federal level, it is notable that the trends for each of the provinces shown in figure 2 are roughly parallel.

But the trends across provinces are not at all parallel in figure 3 for the CCPCs coded as doctors' offices. The difference between Ontario and the other provinces is an even more dramatic indication of the results of this (quasi) "natural experiment." The obscure budget change in Ontario in 2005 is associated with a dramatic spurt of growth in the numbers of CCPCs only in Ontario. The other provinces show no such spurt. Correspondingly, there were no comparable changes in their laws and regulations regarding incorporation of professionals.

The most likely explanation for the differential Ontario trend in the number of physician CCPCs is that allowing doctors' family members to own non-voting shares opened the possibility for their CCPCs to pay dividends to the owners' spouse and older children, and thereby achieve a substantial amount of income splitting.

FIGURE 3 Trends in the Number of Physician CCPCs in the Four Largest Provinces, 2001-2011



CCPC = Canadian-controlled private corporation.

CONCLUDING COMMENTS

The results just presented represent a significant step in our project to create and then analyze the unprecedented data resulting from linking individuals' income tax returns (T1s) to those of private companies that they own (T2s) plus the associated employment income tax slips (T4s) and the investment income tax slips with information on the dividend income flows (T5s) received by the owners of these companies and their immediate family members.

These private companies, formally, are "Canadian-controlled private corporations" as defined in the Income Tax Act.[35] CCPCs are a social construction. Their many provisions in the Act, along with CRA's various rulings and interpretations, represent an accumulation of policy choices over many years. To the extent that the resulting tax provisions provide preferential tax treatment, the result is a "tax expenditure." As emphasized by the auditor general in his 2015 spring report, these tax expenditures should really be considered spending programs that happen to be delivered as part of the income tax system.[36]

Importantly, as the auditor general observed, these de facto programs managed by the Department of Finance are chronically devoid of public and parliamentary

35 RSC 1985, c. 1 (5th Supp.), as amended, subsection 125(7).

36 Supra note 15.

scrutiny, virtually never publicly evaluated, and generally impossible to understand owing to the systematic lack of relevant data.[37]

In this study, a sequel to Wolfson et al.,[38] we have endeavoured to shine more light on the ways a number of taxpayers are using CCPCs. The popular rhetoric is that the special low small business tax rate available to CCPCs is designed to support small businesses, in part because they face greater challenges than larger businesses in areas such as financing, and because they are believed to be major sources of job creation and entrepreneurship. However, our analysis suggests that roughly half a billion dollars annually is forgone in ways related primarily to income splitting, where no such benefits are generated.

In this context, it is indeed unusual, in the lead-up to the 2015 federal election, that both the Conservatives and the New Democratic Party (NDP) have endorsed further lowering of the small business tax rate. For example, the Conservatives have said:

> The Government of Canada is committed to ensuring the continued success of Canadian businesses and promoting the creation of high-quality jobs. To this end, on April 23, 2015, Prime Minister Stephen Harper announced the proposed cut to the federal small business tax rate, which will help small businesses prosper from coast to coast to coast. . . . This preferential rate allows small businesses to retain more earnings that can be used to reinvest and create jobs.[39]

Similarly, the NDP have said:

> We'll provide immediate and permanent help for Canada's hard working small business people who are the backbone of local communities and the creators of 80% of all new jobs in this country. We'll start by cutting the small business tax rate from 11 to 10 to 9%, a near 20% reduction. With this one practical measure, small businesses can better weather the current economic climate, hire more employees and help their local communities prosper for years to come.[40]

However, neither party has said anything about how this expansion of the benefits of preferential tax treatment for CCPCs should be targeted. This is especially concerning when, as we have shown, substantial tax benefits are likely flowing to a select group of mostly higher-income families where the objectives of supporting worthy

37 Ibid., at paragraph 3.77: "[T]he Department fell short on managing tax-based expenditures. We reached this conclusion because these expenditures were not systematically evaluated and the information reported did not adequately support parliamentary oversight."

38 Wolfson et al., supra note 9.

39 Prime Minister of Canada, "Small Business Tax Rate Reduction," April 23, 2015 (www.pm.gc.ca/eng/news/2015/04/23/small-business-tax-rate-reduction).

40 "Kickstarting Manufacturing and Small Business Job Creation: Tom Mulcair's Speech to the Canadian Economic Club (Ottawa)," January 27, 2015 (www.ndp.ca/news/kickstarting-manufacturing-and-small-business-job-creation).

objectives such as entrepreneurship and job creation are unlikely to be realized. It is left implicit by the two political promises that enriching these substantial tax benefits will in fact serve these socially agreed and worthy objectives.

Moreover, questions of horizontal equity have not been addressed. Why should an employed scientist or manager with comparable education and skills have to pay more taxes than an incorporated lawyer or doctor receiving a similar income?

The data we have analyzed suggest that the proposed small business tax rate cuts, in the absence of more substantial policy analysis, will be poorly targeted. Of course, some of the benefits of lowering the small business tax rate will accrue to bona fide small businesses. But it is also highly likely that the changes will exacerbate both horizontal and vertical inequities, with substantial tax benefits accruing to wealthy families who face no financing challenges, and who are most unlikely to create any new jobs as a result.