Is the Income-Splitting Tax Needed? Some Empirical Evidence

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PRÉCIS

Le budget fédéral de 1999 propose que certains types de dividendes et de revenus tirés d'entreprises, qui sont perçus par des personnes de moins de 18 ans, soient imposés au taux maximal le plus élevé plutôt qu'aux taux progressifs normaux. Afin d'apporter quelques donnés empiriques pour la discussion de cette proposition, cet article examine l'ensemble des statistiques annuelles du régime d'impôt sur le revenu des particuliers. Si la tranche des moins de 20 ans (catégorie mentionnée la plus proche de la tranche des moins de 18 ans) reçoit une part des revenus les plus susceptibles de faire l'objet de fractionnement de revenu, et que cette part est supérieure de manière disproportionnée à la part reçue par la tranche des 20 à 24 ans, ou si sa part de ces types de revenus a augmenté au cours des années dans une mesure disproportionnée par rapport à la part de la tranche des plus âgés, on peut en conclure qu'il existe une activité de fractionnement de revenu.

L'article note que la preuve la plus évidente du fractionnement de revenu est présente dans le cas des revenus sous forme de dividendes. Le revenu total des dividendes (avant leur majoration) déclaré par les moins de 20 ans a augmenté 5 fois, passant de 51 millions $ en 1986 à 253 millions $ en 1996 (année la plus récente pour laquelle nous avons pu obtenir des données); par contre, le revenu en dividendes déclaré par les 20 à 24 ans n'a pas augmenté durant cette même période. En 1996 le revenu total en dividendes déclaré par ceux dans le groupe des moins de 20 ans dépassait de 370 % le montant déclaré par la tranche des 20 à 24 ans, alors que le ratio correspondant pour les autres revenus d'investissements n'était que de 62 %.

Le fractionnement de revenu semble se pratiquer également pour les revenus nets tirés d'entreprises et les gains en capital. Les montants des revenus nets tirés d'entreprises et des gains en capital déclarés par la tranche des moins de 20 ans a augmenté nettement de 1986 à 1996, mais cette tendance temporelle était absente dans les montants déclarés par la tranche d'âge des 20 à 24 ans. En outre, les gains en capital des moins de 20 ans étaient supérieurs de manière disproportionnée à ceux du groupe des plus âgés.

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Étant donné la proportion des moins de 20 ans qui déclarent des revenus de dividendes et des revenus nets tirés d'entreprises, il semble que moins d'un pour cent des Canadiens de moins de 20 ans participent au fractionnement de revenu, mais même dans ce cas, on estime que les recettes de l'impôt proposé sur le fractionnement de revenu atteindront environ 115 millions $ par an. Bien entendu, en pratique cet impôt spécial n'augmenterait pas cette recette car les contribuables pourraient réagir en restructurant leurs affaires; ce chiffre cependant représente la perte possible de recettes si l'impôt n'était pas appliqué.

Le chiffre de 115 millions $ est basé sur les montants déclarés pour les revenus en dividendes et ceux tirés d'entreprises. Ces montants toutefois comprennent les dividendes versés par des compagnies publiques et les revenus tirés d'entreprises auxquelles aucun membre de la famille ne participe et qui donc ne seraient pas affectés par la proposition du budget. Par conséquent, le chiffre de 115 millions $ surestime peut être l'incidence réelle du fractionnement des revenus. Ou encore, ce chiffre pourrait avoir été sous-estimé : le fractionnement des revenus pourrait avoir augmenté depuis 1996, de nombreux mineurs avec des revenus peu élevés susceptibles de faire l'objet de fractionnement peuvent ne pas présenter de déclaration d'impôt, et il n'est pas possible de distinguer la différence entre les revenus provenant de fiducies à partir des données.

ABSTRACT

The 1999 federal budget proposes that certain types of dividend and business income received by individuals under the age of 18 be taxed at the top marginal rate rather than at the normal graduated rates. The purpose of this article is to contribute some empirical evidence to the discussion of this proposal by examining Revenue Canada's annual publications of aggregate statistics on the personal income tax system. If the under-20 age group (the published category closest to the under-18 group) receives a share of the types of income most amenable to income splitting that is disproportionately large relative to the share received by the 20-24 age group, or if its share of these types of income has grown over time by disproportionately more than the older group's share has grown, then one may infer that income-splitting activity exists.

The article finds that the clearest evidence of income splitting occurs in the case of dividend income. Total dividend income (before gross-up) reported by individuals under age 20 has increased fivefold, from $51 million to $253 million, between 1986 and 1996 (the most recent year for which data are available), whereas dividend income reported by individuals aged 20-24 did not increase over the period. In 1996, moreover, total dividend income reported by the under-20 group was 370 percent of the amount reported by the 20-24 age group, though the corresponding ratio for other investment income was just 62 percent.

Income splitting also seems to occur in the cases of net business income and capital gains. The amounts of net business income and capital gains reported by the under-20 group rose sharply between 1986

and 1996, whereas there was no such time trend in the case of the amounts reported by the 20-24 age group. Furthermore, the capital gains received by the under-20 group are disproportionately large relative to those received by the older group.

Given the proportions of the under-20 population that report dividend income or net business income, it appears that less than one-half of 1 percent of Canadians under age 20 participate in income splitting. Even so, the revenue impact of the proposed income-splitting tax is roughly estimated to be $115 million annually. Of course, the special tax would not raise that amount, since taxpayers would respond to it by rearranging their affairs; rather, this figure represents the possible revenue loss if the tax were not imposed.

The figure of $115 million is based on the reported numbers for dividend and business income. These numbers, however, include dividends from public corporations and income from business activities in which no relative participates, which the budget proposal would not affect. Thus the figure of $115 million may overstate the amount of income splitting that actually occurs. Alternatively, the figure may be an understatement: income splitting may have increased since 1996, many minors with small amounts of income amenable to income splitting may not be filing tax returns, and the amount of trust income cannot be identified from the data.

INTRODUCTION

Attribution rules to prevent income splitting among family members have been part of the law since the introduction of income tax in Canada in 1917, but they have been significantly amended only in 1985[1] and again in a 1999 budget proposal. The impetus for the new proposal appears to come from the *McClurg*[2] and *Neuman*[3] cases, which seem to allow taxpayers to sprinkle dividends on shares issued for nominal consideration to family members, and from a growing belief that management-services family trusts and limited partnerships also avoid attribution.[4] In response

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[1] The history of the attribution rules and the changes made as a result of the 1985 budget are reviewed in William J. Strain, David A. Dodge, and Victor Peters, "Tax Simplification: The Elusive Goal," in *Report of the Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 4:1-63, at 4:26-29; and Claire F.L. Young, "The Attribution Rules: Their Uncertain Future in the Light of Current Problems" (1987), vol. 35, no. 2 *Canadian Tax Journal* 275-313, at 280-83. A recent but less significant amendment is the extension in 1989 of attribution to certain interest-free or low-interest loans made to non-arm's-length parties. See subsections 56(4.1) through (4.3) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] *The Queen v. McClurg*, 91 DTC 5001 (SCC).

[3] *Neuman v. The Queen*, 98 DTC 6297 (SCC).

[4] In *The Queen v. Ferrel*, 99 DTC 5111 (FCA), the court held that payment of management fees to a trust was not subject to the indirect-payment rule in subsection 56(2) of the Act.

to the view that the present attribution rules have become so deficient that they are "more likely to trap the unwary than effectively bridle income splitting,"[5] the 1999 budget proposes that certain types of income received by individuals aged 17 or under be taxed at the top marginal rate rather than at the normal graduated rates. The budget states that this proposal would apply to two types of income:

• taxable dividends and other shareholder benefits on unlisted shares of Canadian and foreign companies (received directly or through a trust or partnership); and

• income from a partnership or trust where the income is derived by the partnership or trust from the business of providing goods or services to a business carried on by a relative of the child or in which the relative participates.[6]

The policy debate surrounding the attribution rules has always centred on whether the increase in fairness[7] and prevention of revenue loss achieved by the rules justifies the concomitant increase in complexity and the resulting compliance cost burden on taxpayers. Many practitioners feel that prevention of revenue loss is the paramount motive behind the rules; for example, the 1985 changes[8] provoked the charge that "the policy behind the attribution rules is driven solely by revenue considerations,"[9] and the 1999 proposal has been characterized as a "tax grab" and an "attack on the self-employed."[10] The government has not been helpful in providing

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[5] Jack Bernstein, "Income-Splitting Tax Details" (June 22, 1999), 7 *Canadian Tax Highlights* 43-44, at 43. Other articles on the proposal are: Ernst & Young LLP, "1999 Federal Budget: The Death of Income Splitting," *Ernst & Young LLP Tax Brief* TB 99-05, February 1999; Jack Bernstein, "Income-Splitting Tax" (March 16, 1999), 7 *Canadian Tax Highlights* 20-21; Charles M. Rotenberg, "Lies, Damned Lies and Misleading Statistics" (March 16, 1999-April 5, 1999), 21 *The Canadian Taxpayer* 43-45; Tim Cestnick, "How To Use Family Trusts," *The Globe and Mail*, July 3, 1999; and Jack Bernstein, "Proposed Income-Splitting Tax," *The Estate Planner*, no. 52 (North York, Ont.: CCH Canadian, May 14, 1999), 1-2.

[6] Canada, Department of Finance, 1999 Budget, The Budget Plan, February 16, 1999, 193.

[7] For a discussion of whether the attribution rules increase fairness, see Strain, Dodge, and Peters, supra footnote 1. The attribution rules will inevitably be overinclusive in some situations and therefore will decrease fairness for some taxpayers. For example, the new proposal applies to dividends received by young entrepreneurs from their incorporated businesses.

[8] As a result of the 1985 budget, the attribution rules in section 74 and subsection 75(1) were replaced with a more specific set of rules in sections 74.1 through 74.5. Whereas the previous rules covered only transfers of property to a spouse or minor, the new rules covered loans of property as well. The new rules also applied to certain transfers and loans to a corporation (other than a small business corporation) of which a spouse or minor was a shareholder, though the original rules in section 74.4 were later replaced retroactive to their date of introduction. For discussion, see the references in supra footnote 1.

[9] Strain, Dodge, and Peters, supra footnote 1, at 4:31. In an equally extreme view, the government claimed in 1988 that equity considerations alone drive policy in this area: ibid., at 4:38.

[10] Tim Cestnick, "Business Owners Have Much To Squawk About," *The Globe and Mail*, April 10, 1999.

revenue information; the 1999 budget documents simply enter a "—" for the proposal in the table of revenue impacts of budget measures, with the unenlightening footnote "[s]mall, non-existent or prevents revenue loss."[11]

The purpose of this article is to contribute some empirical evidence to this discussion. It uses Revenue Canada's annual publications of aggregate statistics on the personal income tax system to examine the amounts of various types of income received by children for evidence of income splitting and its extent. Although the preferred age categorization would be individuals under age 18, since this age is the dividing line used in the attribution rules, the closest approximation available in the published data is individuals under age 20. This approximation may be not too far off, since perhaps only 10 percent of the group is included inappropriately.[12]

The analysis compares the amounts of income reported by individuals under 20 with the amounts reported by individuals aged 20 to 24 in order to identify amounts that may arise from splitting income with family members. In effect, the 20-24 age group serves as a control group that allows one to distinguish income splitting from other economic factors that determine incomes. The two groups are similar because of their closeness in age, and if anything one would expect the 20-24 group, because of its greater maturity, its entry into the full-time labour force, and compound interest, to have higher incomes of all types than the under-20 group. Income splitting, however, would be much less prevalent in the older group because of its members' generally higher incomes from other sources. Hence, given income of a certain type, if the ratio of the amount received by the under-20 group to the amount received by the 20-24 group is disproportionately large relative to the ratios for other, similar income types, then income splitting may be suspected.

One might argue that this comparison is bound to overstate income splitting for tax purposes, since parents may transfer assets to minor children for estate-planning reasons or to protect the assets from creditors. Nevertheless, tax saving does take place in these situations, at least until the marginal tax rates of the parent and the child are equalized. The fact that the tax saving is a side effect rather than the primary purpose of the exercise does not take away the reality of its occurrence.

A further way in which we test for income splitting is by making comparisons over time. Since 1985, the financial press has given more and more attention to the possibilities for income splitting. Thus, if certain types of income are increasing over time for the under-20 group but are remaining constant or increasing at a much lower rate for the 20-24 group, there is even more reason to suspect income splitting.

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[11] Supra footnote 6, at 178.

[12] The percentage of the under-20 population aged 18 or 19 has decreased steadily from 10.8 percent in 1986 to 10.0 percent in 1996 (Statistics Canada, CANSIM database, matrix 6367). However, the proportion of taxfilers aged 18 or 19 reporting the various types of income examined in this study is not available.

This article is based primarily on data for 1996, the most recent year for which data are available. The primary analysis is supplemented by comparisons over time as far back as 1986, the first full year after the last major set of attribution-rules reforms.[13] We devote particular attention to dividend income and business income, which are the subject of the 1999 budget proposal.

SOURCES OF INCOME

Revenue Canada's *Income Statistics* currently categorizes income into 20 different types.[14] Table 1 lists the 10 types of income that were most important for the under-20 group in Canada as a whole in 1996. The table shows the amounts for each of these income types for the under-20 group, the comparison amount for the 20-24 age group, and the ratio (in percentage terms) of the under-20 amount to the 20-24 amount. Of course, the number of individuals in the population under 20 years of age is much larger than the number aged 20-24 (8,005,000 versus 2,011,000).[15] Thus, if every individual in these two age groups had the same income, the ratio of incomes of the two groups would be 398 percent. This figure may serve as one yardstick in examining the first column of ratios for the different types of income in table 1.

Let us begin by examining the types of income of the under-20 group that are not expected to involve income splitting. One obvious type is government transfers-tax-exempt income and Canada Pension Plan/Quebec Pension Plan (CPP/QPP) benefits. Another is other income, which includes such elements as scholarship income and registered educational savings plan income. Although other income does also include income from limited partnerships, which could be the result of income splitting, the category is too broad to interpret in this manner. Finally, there are employment income and other employment income. Although these types of income could be the product of income splitting to the extent that they represent employment compensation from family businesses that is in excess of fair value for services rendered,[16] they are not disproportionately received by the under-20 group. The ratio of the amount of employment income reported by the under-20 group to the amount reported by the 20-24 group is 20 percent. The ratio for other employment income, which includes, among other items, tips and gratuities and shareholders' loans, is 39 percent. These ratios are both well below the population-based standard of 398 percent.

[13] The attribution rules in sections 74.1 and 74.2 apply to transfers and loans made after May 22, 1985, and to loans made on or before that date if they were not repaid before 1988.

[14] Revenue Canada, *Income Statistics: 1996 Tax Year* (Ottawa: Revenue Canada, 1998), 166-72.

[15] Supra footnote 12.

[16] Income splitting of this type borders on tax evasion; in contrast, the income splitting detected through data analysis in this article is no doubt perfectly legal.

Table 1 Total Amounts of Various Sources of Income, 1996 Taxation Year—All Returns

Source	All Canadians			Ontario residents			Quebec residents		
	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)
Employment income	3,418	16,892	20	1,253	6,284	20	754	3,748	20
Taxable amount of dividends	316	86	370	128	34	381	14	17	84
Tax-exempt income	237	1,253	19	103	521	20	61	265	23
Other income	160	403	40	63	130	48	27	119	22
Other investment income	146	233	62	76	122	62	17	40	43
Taxable capital gains	74	64	116	39	25	156	5	8	59
Other employment income	69	175	39	39	76	51	4	24	15
Net business income	62	231	27	40	86	46	3	23	11
CPP/QPP benefits	33	88	38	17	50	33	4	6	62
Net farming income	27	66	41	2	8	25	1	2	38
All other sources	102	1,219	8	26	297	9	36	326	11
Total income assessed	4,644	20,711	22	1,786	7,632	23	925	4,578	20

Sources: National figures are from Revenue Canada, *Income Statistics: 1996 Tax Year* (Ottawa: Revenue Canada, 1998), basic table 4, at 90-91. The types of income are defined ibid., at 166-72. Ontario and Quebec figures are from unpublished data available from Revenue Canada. Ratios are calculated using the Revenue Canada data.

This leaves five types of income—the taxable amount of dividends from taxable Canadian corporations, net business income, net farming income, other investment income, and taxable capital gains. Consider the first item, dividend income: $316 million is received by the under-20 group but only $86 million by the 20-24 age group. Thus the ratio of the under-20 receipts to the 20-24 receipts is 370 percent. Although one might expect dividend income to be higher for the under-20 group than for the 20-24 group, since the former age group is almost four times larger than the latter, a review of this ratio for the other types of income in table 1 shows clearly that dividends are an anomaly. In other words, if the income amounts were determined simply by the size of each age group, then this fact should also be evident for income types other than dividends. However, the amount of other investment income (which includes interest, income from trusts other than Canadian dividends,[17] and foreign income), for example, is much less for the under-20 group than it is for the 20-24 group; the former is just 62 percent of the latter.[18]

The only type of income other than dividends that is especially high for the under-20 group is taxable capital gains; the amount earned by the under-20 group is 116 percent of the amount earned by the 20-24 group. In the case of this income category, therefore, there is some evidence of income splitting.

Net business income and net farming income are not especially high for the under-20 group relative to most other types of income. If, however, one views income of this kind as a variety of labour income, then it is high relative to the 20 percent that is the ratio of under-20 employment income to employment income for the 20-24 group. The income-splitting interpretation is reinforced by the evidence presented below on the time trend of net business income. One might think it unlikely that business or farming income would be the result of income splitting, since income of this kind that is flowed through a trust is categorized in the Revenue Canada data as other investment income rather than as net business or farming income. Given the observed time trends in the data, though, parents must be using other income-splitting arrangements, such as partnerships with their children or management fees paid directly to their children.

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[17] The inclusion of trust income in the broad category called "investment income" (which is required by the loss of detail associated with e-filing) makes it impossible to isolate income-splitting behaviour involving the use of trusts after 1992, the last year for which separate data on such income is available. The only time trend during the 1986-1992 period is a drop in trust income for the under-20 group, from $70 million in 1986 and 1987 to about $20 million annually thereafter (Revenue Canada, *Taxation Statistics* [continues as *Tax Statistics on Individuals* and now *Income Statistics*] [Ottawa: Revenue Canada, annual]). The reason is probably that attribution began January 1, 1988 for income from property acquired with non-commercial-rate loans made before May 23, 1985 (subsection 74.1(2)).

[18] This article uses the term "other investment income" in place of the Revenue Canada term "investment income" to make it clear that Canadian dividends are not included.

The three middle and the three rightmost columns of table 1 show the amount of the same types of income for residents of Ontario and Quebec, respectively. One difference is that income splitting using dividends is much less prevalent in Quebec than it is in Ontario. Dividends account for 7.2 percent of total income for the under-20 group in Ontario but only 1.5 percent for the under-20 group in Quebec. Moreover, the ratio of the under-20 group's amount to the 20-24 group's amount is close to the national average (370 percent) in Ontario (381 percent) but much lower in Quebec (84 percent).[19] Quebec's 84 percent ratio for dividends, though, is still high relative to its ratio for other investment income (43 percent), so income splitting through dividends is still discernible in this case.

Ontario also shows much stronger evidence of income splitting through taxable capital gains. In this case, Ontario's ratio (156 percent) is much higher than the national average (116 percent), whereas Quebec's is much lower (59 percent).

TIME TRENDS

Table 2 shows the time pattern of dividends from 1986, the first full year following the last set of attribution-rules reforms,[20] to 1996, the most recent year for which data are available. The table makes its comparisons in terms of the actual amount of dividends rather than the taxable amount, since the gross-up rate has varied over time.

The table suggests that income-splitting activity has increased over time. There is no particular time trend for the 20-24 age group, but for the under-20 group both the number of returns that reported dividend income and the amount of dividend income per return increased between 1986 and 1996. The number of returns in 1996 was more than triple the number in 1986, and the ratio of the number of returns that reported dividend income for the under-20 group to the number that reported it for the 20-24 group rose over the period from 34 percent to 87 percent. The pattern is similar for the amount of dividend income per return that reported dividend income. The average amount reported for the 20-24 group fell over the 1986-1996 period, whereas the average for the under-20 group rose more or less steadily from about $4,200 to about $6,400.[21]

The total amount of dividends reported for the under-20 group was influenced by both of these trends; thus it rose from $51 million in 1986

[19] One possible cause could be differences in provincial income tax rules between Quebec and Ontario.

[20] Supra footnote 13.

[21] These low average amounts would seem to suggest income splitting with children generally stops at levels well before the children start to pay tax (for example, $24,000 of dividend income). There is no way of knowing from aggregate data, however, how many children receiving dividends also have other sources of income or if the median amount of income is much different from the mean.

Table 2 Actual Amount of Dividends by Taxation Year, 1986-1996—All Returns

	Number of returns reporting			Population		Amount per return reporting			Total amount reported		
	Age < 20	Age 20-24	Ratio (%)	Age < 20	Age 20-24	Age < 20 ($)	Age 20-24 ($)	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)
1986	12,090	36,040	34	7,472,000	2,446,000	4,246	2,002	212	51	72	71
1987	15,700	37,220	42	7,484,000	2,363,000	4,146	2,057	202	65	77	85
1988	15,500	34,540	45	7,521,000	2,258,000	4,015	1,604	250	62	55	112
1989	16,230	37,230	44	7,596,000	2,186,000	4,619	1,717	269	75	64	117
1990	17,850	34,770	51	7,671,000	2,124,000	4,727	1,751	270	84	61	139
1991	18,050	36,430	50	7,718,000	2,088,000	6,938	1,929	360	125	70	178
1992	19,240	31,320	61	7,798,000	2,072,000	6,261	1,706	367	120	53	226
1993	24,240	33,470	72	7,860,000	2,051,000	6,722	1,852	363	163	62	263
1994	32,290	39,710	81	7,920,000	2,032,000	7,074	1,680	421	228	67	342
1995	34,460	40,460	85	7,960,000	2,018,000	8,880	1,740	510	306	70	435
1996	39,310	45,120	87	8,005,000	2,011,000	6,436	1,516	425	253	68	370

Note: The actual amounts of dividends are computed from the reported taxable amounts of dividends by removing the gross-up. The gross-up is one-half for 1986, one-third for 1987, and one-quarter for subsequent years.

Sources: Numbers of returns and total amounts reported are from Revenue Canada, *Income Statistics* (formerly *Tax Statistics on Individuals* and *Taxation Statistics*) (Ottawa: Revenue Canada, annual), basic table 4. Amounts per return and ratios are calculated using the Revenue Canada data. Population figures are from Statistics Canada, CANSIM database, matrix 6367.

to $253 million in 1996.[22] Again, the 20-24 age group shows no particular pattern, and the group's reported dividends ranged between $53 million and $77 million over the period.

It is difficult to find any explanation for these time trends other than income splitting. The increase in the total amount of dividends received by the under-20 group is not attributable to inflation, since the consumer price index (CPI) increased by only 36 percent between 1986 and 1996.[23] It also cannot be explained by the increase in the under-20 population, which was only 7 percent over the entire period, or by more voluntary filing of returns by individuals with small amounts of dividends: the proportion of the under-20 population that filed a tax return was 10.6 percent in 1986 and 10.5 percent in 1996, with small fluctuations without trend in between.[24] Similarly, the differences between the two age groups' time trends are only partially attributable to changing demographics—that is, the 7 percent increase in the under-20 population and an 18 percent decrease in the population aged 20-24.[25] The proportion of the under-20 population that received dividends roughly tripled between 1986 and 1996 (from 0.16 percent to 0.49 percent), whereas the increase for the 20-24 group was much smaller (from 1.47 percent in 1986 to 2.24 percent in 1996).

Table 3 shows that the net business income of the two age groups has changed over time as well. Like the number of under-20 returns that reported dividends, the number of returns that reported net business income jumped sharply between 1986 and 1996, and again the jump did not occur in the number of returns for the 20-24 control group. The average amount of net business income per return, however, shows no strong pattern over the period for either group, although there was a slight upward drift for the under-20 group.[26] Hence the increase in the total amount of net business income reported by the under-20 group, from $18 million in 1986 to $62 million in 1996, was driven mostly by the increase in the number of under-20 returns that reported net business income.

The left side of table 4 shows the time trends in capital gains income for the under-20 group and the 20-24 group. For both groups, the number of returns that reported capital gains increased over the 1986-1996 period, but the increase was much larger for the under-20 group. The total amount reported in 1996 by the under-20 group was almost triple the amount reported by that age group in 1986, whereas the amount reported by the 20-24

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[22] The $253 million of actual dividends corresponds to the $316 million in taxable dividends reported in table 1, since $253 million plus the 25 percent gross-up equals $316 million.

[23] Statistics Canada, CANSIM database, matrix 9957.

[24] The population figures are from supra footnote 12, and the numbers of tax returns are from supra footnote 17.

[25] Supra footnote 12.

[26] Possibly the limitation of deductions to reasonable amounts by section 67 limits the amounts here.

Table 3 Net Business Income by Taxation Year, 1986-1996—All Returns

	Number of returns reporting			Population		Amount per return reporting			Total amount reported		
	Age < 20	Age 20-24	Ratio (%)	Age < 20	Age 20-24	Age < 20 ($)	Age 20-24 ($)	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)
1986	5,110	45,160	11	7,472,000	2,446,000	3,477	3,922	89	18	177	10
1987	5,750	46,010	12	7,484,000	2,363,000	2,877	4,593	63	17	211	8
1988	5,360	44,080	12	7,521,000	2,258,000	4,208	5,095	83	23	225	10
1989	5,690	45,840	12	7,596,000	2,186,000	4,358	4,433	98	25	203	12
1990	5,860	42,220	14	7,671,000	2,124,000	4,797	4,581	105	28	193	15
1991	5,710	39,820	14	7,718,000	2,088,000	3,526	3,771	94	20	150	13
1992	6,900	38,370	18	7,798,000	2,072,000	4,534	4,235	107	31	163	19
1993	8,500	45,560	19	7,860,000	2,051,000	4,318	4,219	102	37	192	19
1994	12,800	47,880	27	7,920,000	2,032,000	3,447	4,314	80	44	207	21
1995	12,040	52,350	23	7,960,000	2,018,000	4,563	4,114	111	55	215	26
1996	14,870	53,110	28	8,005,000	2,011,000	4,160	4,354	96	62	231	27

Sources: Same as table 2.

group did not increase. A pattern is hard to discern, however, since capital gains vary widely over time. The large and temporary increase in 1994 in the amounts of income reported was a consequence of the ending of the $100,000 capital gains deduction.

The right side of table 4 deals with other investment income. In contrast to the total amounts of dividend income, net business income, and capital gains reported by the under-20 group, the total amount of other investment income reported by this group did not increase steadily over time. It is possible that the decline in interest rates over this period obscures an increase in income-splitting activity. The number of people under age 20 who reported other investment income did increase substantially between 1993 and 1996 (the period for which data are available).[27]

THE REVENUE IMPACT OF THE BUDGET PROPOSAL

The data can also be used to produce an estimate of the revenue impact of the 1999 budget proposal. From table 2, the actual amount of dividends received in 1996 by the under-20 group was $253 million. Since the marginal tax rate on dividends for a top-bracket taxpayer is about 33 percent, subjecting these dividends to the income-splitting tax would raise $83 million. For business income, from table 1, the sum of net business income and net farming income is $89 million. If one adds another $10 million of net fishing income, $7 million of net professional income, and $3 million of net commission income[28] and multiplies the total ($109 million) by an estimated 50 percent marginal rate, the result is $55 million of tax on business income. If one combines the amounts of tax on the two types of income ($83 million and $55 million) and reduces the total by 10 percent to exclude amounts received by children aged 18 and 19[29] and a further 5 percent to allow for the tax that some children already pay on the income,[30] it appears that the income-splitting tax might raise $115 million annually. Of course, the special tax would not actually raise that amount, since

[27] For the earlier years, 1986-1992, only the number of returns that reported each of a set of subcategories of other investment income is available.

[28] Supra footnote 14, at 90-91. Net fishing income, net professional income, and net commission income are included because, as income from business, they too would be covered by the budget proposal. Net commission income excludes commissions from employment.

[29] In 1984, the last year for which such data are available, 90 percent of the returns filed by the under-20 group with tax payable of at least $1 were for individuals aged 18 or 19 (Revenue Canada, *Taxation Statistics: 1986 Edition* [1984 taxation year] [Ottawa: Revenue Canada, 1986], 236-37). This figure might suggest that 10 percent is too low. The 90 percent figure, however, is probably attributable to employment income. As tables 2 and 3 show, it is not likely to be representative of the returns reporting dividend or business income, since the per-capita amounts of this income received by the 20-24 group are equal to or less than the amounts received by the under-20 group.

[30] In 1996, only 23 percent of under-20 returns had tax payable of at least $1, and in those returns total tax payable was only 9 percent of total income assessed (supra footnote 14, at 90-91 and 104-5 respectively). These are averages based on all returns; the figures might be higher for the returns of children in receipt of these types of income.

Table 4 Capital Gains and Other Investment Income by Taxation Year, 1986-1996—All Returns

	Capital gains						Other investment income					
	Number of returns reporting			Total amount reported			Number of returns reporting			Total amount reported		
	Age < 20	Age 20-24	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)	Age < 20	Age 20-24	Ratio (%)	Age < 20 ($ millions)	Age 20-24 ($ millions)	Ratio (%)
1986 . . .	5,390	17,660	31	35	90	39	na	na	—	167	344	49
1987 . . .	8,880	22,040	40	74	135	55	na	na	—	163	321	51
1988 . . .	5,050	13,460	38	56	103	54	na	na	—	150	327	46
1989 . . .	8,070	15,860	51	72	120	60	na	na	—	179	396	45
1990 . . .	5,050	12,630	40	55	92	59	na	na	—	205	452	45
1991 . . .	5,610	12,150	46	53	63	84	na	na	—	195	398	49
1992 . . .	8,590	15,660	55	78	90	87	na	na	—	153	282	54
1993 . . .	16,810	28,780	58	152	120	127	164,560	319,180	52	124	221	56
1994 . . .	22,310	30,580	73	287	172	167	164,140	282,700	58	118	182	65
1995 . . .	21,870	30,020	73	140	73	191	191,610	338,150	57	156	221	70
1996 . . .	32,740	43,820	75	99	85	116	206,160	338,630	61	146	233	62

na not available.

Note: Capital gains are calculated from the reported amount of taxable capital gains by adding the non-taxable fraction (one-half for 1986 and 1987, one-third for 1988 and 1989, and one-quarter for subsequent years). Capital gains for 1994 exclude the special capital gains election relating to the phase-out of the general capital gains deduction in that year. Other investment income includes interest, income from trusts other than Canadian dividends, and foreign income.

Sources: Numbers of returns and total amounts reported are from Revenue Canada, *Income Statistics* (formerly *Tax Statistics on Individuals* and *Taxation Statistics*) (Ottawa: Revenue Canada, annual), basic table 4. Ratios are calculated using the Revenue Canada data.

taxpayers would respond to it by rearranging their affairs. Rather, the figure represents the possible revenue loss if the tax were not imposed.

This figure may be too high, since not all of the two types of income would be subject to the income-splitting tax. In particular, some of the dividends in the Revenue Canada statistics are from public corporations and some of the business income is from a business activity in which no relative participates. It is also possible that taxpayers would successfully avoid the income-splitting tax by, for example, recharacterizing business income as employment income. On the other hand, the figure may be too low. Revenue Canada statistics do not include the income of children who do not file returns (because they have insufficient income to pay tax). Trust income, limited partnership income, and shareholder benefits, all of which would be subject to the income-splitting tax in certain circumstances, are not included in our calculations here. The final consideration, and perhaps the most important one, is that because of recent judicial decisions that have supported income splitting, the amounts of income that are split with minor children may have increased greatly since 1996.

CONCLUSION

In summary, a comparison of the amounts of income of certain types received by the under-20 age group and the amounts received by the 20-24 age group reveals an unmistakable pattern of income-splitting behaviour. Moreover, this behaviour has increased since the last major reform of the attribution rules in 1986. Income splitting seems to be most significant in the contexts of dividend income and net business income, which are precisely the types of income caught by the 1999 budget proposal. Dividend income reported by the under-20 group is 370 percent of the amount reported by the 20-24 group, whereas the equivalent ratio for other investment income is just 62 percent. Also, whereas the dividend income and net business income reported by the 20-24 age group did not grow between 1986 and 1996, the dividend income reported by the under-20 group increased fivefold and the net business income tripled.

It is possible to use the Revenue Canada data to extend this analysis as far back as 1975.[31] What is surprising is that the 1985 expansion of the attribution rules does not generally appear to have been a response to growth in income splitting;[32] indeed, income splitting for dividends, business income, and capital gains appears to have become more common after the changes were introduced. For example, in the 1975-1986 period, total dividends received by the under-20 group varied without any trend between

[31] The data for the years before 1975 include all individuals under age 25 in a single age category. Though data on the total reported amount of each type of income are available as far back as 1975, figures for the number of returns that report each type are available only as far back as 1981.

[32] An exception may be income from trusts other than Canadian dividends. See supra footnote 17.

66 percent and 95 percent of the amount received by the 20-24 age group. The sharp increase in this ratio that table 2 above reports began later.

An interesting question raised by the 1999 budget proposal is why the rules were not extended to cover capital gains, since similar income-splitting behaviour is also evident in this area. Although the evidence is not as clear in this case as it is in the cases of dividend income and net business income, capital gains are disproportionately received by the under-20 group and the ratio of the total amount received by the under-20 group to the amount received by the 20-24 group has approximately tripled in 10 years. One problem with applying the new tax to capital gains is that, for consistency, it would probably also be necessary to extend the attribution rules to capital gains received by minors. In addition, the tax would be avoidable to the extent that realizations could be delayed until age 18.

Some possible reasons for the increase in income splitting between parents or other relations and children are the ending of income-tested dependant deductions in 1987, the publicity given to recent court decisions that have upheld income splitting, the perceived reduction in the uncertainty of successfully using income-splitting strategies (partly as a result of the court cases), the increasing wealth of baby-boomer parents, and the need for cash to meet rising private-school tuition.

Income-splitting behaviour seems to be confined to a small segment of the population. In 1996, only 0.49 percent of all individuals under age 20 reported dividend income and only 0.19 percent reported net business income.[33] Even so, the estimated revenue impact of the proposed income-splitting tax is $115 million annually. This figure may be overstated, since it includes dividends from public corporations and income from business activities in which no relative participates. On the other hand, if income splitting has increased since 1996, then the figure of $115 million may understate its revenue impact.

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[33] These figures may be viewed as maximums for the size of the income-splitting population, since an unknown proportion receive these types of income strictly from their own efforts and not as a result of income splitting. On the other hand, these figures exclude what some say is the most common form of income splitting—the payment to family members of salaries that take advantage of what has been aptly characterized as the "reasonable latitude concerning the amounts paid" (Dean Levitt, "Income Splitting Can Pay Dividends," *The Globe and Mail* August 18, 1999).