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Income Sprinkling Using Private Corporations

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The Parliamentary Budget Officer (PBO) supports Parliament by providing analysis, including analysis of macro-economic and fiscal policy, aimed at raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

In July 2017, the Minister of Finance announced consultations on tax planning strategies involving the use of private corporations. This report analyzes potential changes to the taxation of dividends paid to family members of the owners of a Canadian-controlled private corporation (CCPC), one of the policy proposals put forth as part of the consultations and confirmed in Budget 2018. It also reflects clarifications provided by the Minister in December 2017.

This report was written by:
Govindadeva Bernier, Financial Analyst
Tim Scholz, Economic Advisor-Analyst

With comments from:
Mostafa Askari, Deputy Parliamentary Budget Officer
Jason Jacques, Senior Director

Nancy Beauchamp and Jocelyne Scrim assisted with the preparation of the report for publication.

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Please contact pbo-dpb@parl.gc.ca for further information.

Jean-Denis Fréchette
Parliamentary Budget Officer

Table of Contents

Executive Summary

On July 18, 2017, the Minister of Finance announced consultations on tax planning strategies involving the use of private corporations.[1] These consultations included proposed extensions to rules governing the tax on split income (TOSI) aimed at limiting income sprinkling opportunities.

Income sprinkling, also known as income splitting, refers to the ability of a high-income owner of a Canadian-controlled private corporation (CCPC) to arrange the ownership structure of the corporation in order to distribute some of its profits to family members in lower tax brackets. This would reduce the family's overall tax liability.

On December 13, 2017, the Minister published proposals to simplify the treatment of income sprinkling. He presented specific situations in which dividends paid to family members would not be considered as sprinkling income. Thus, they would not be affected by the extended TOSI rules. He also provided thresholds in terms of labour and capital contributions. Budget 2018 confirmed the application of the new rules as laid out in the December 2017 proposal.[2] These new rules have come into effect January 1st, 2018.

This report analyzes the proposed changes to address income sprinkling. The Parliamentary Budget Officer (PBO) was unable to clearly identify the individuals who will be subject to the TOSI rules. Consequently, the PBO computed possible revenue outcomes for the government based on three different scenarios.

Scenario 1 presents our preferred estimate, while scenarios 2 and 3 offer possible lower and upper limits for the revenue estimate.

In all three scenarios, we considered dividends paid to adult family members as not being subject to the TOSI, for individuals where:

- the employment income based on the T4 slip issued by a family owned-CCPC was above a $15,000 threshold;
- if they were 25 years of age or older, they owned at least 10 per cent of the shares of a family-owned CCPC that was not in the service or professional sector;
- they were the spouse of a primary owner aged 65 or over.

Scenario 1

In this scenario, we also excluded all the spouses aged 25 or over from being subject to the new TOSI rules. The rationale behind this scenario is that it is likely that most spouses have assumed some risk in the family business (for example, using the house as collateral for a bank loan to start the business). Therefore, we assume they would pass the reasonableness test and see the dividends they received as being exempt from the TOSI. This is our preferred scenario.

Scenario 2

This scenario is similar to scenario 1. However, we also excluded all children aged 25 and over from being subject to the new TOSI rules. Thus, we assume they have provided some level of labour and/or capital contribution that would be sufficient to pass the reasonableness test.

Scenario 3

This scenario is also similar to scenario 1, but we exclude only spouses of primary business owners outside the professional sector. The rationale is that in some professions, it is possible that the spouse is not assuming risk with respect to the business.

Table S-1 presents our estimates of the change to federal and provincial tax revenues under these three scenarios for fiscal year 2018-2019.

As is expected, scenario 3 generates the highest increase in revenues, and scenario 2 the lowest. We expect the actual value would lie closer to the result of scenario 1, but it could end up between the results of scenarios 2 and 3.

Under scenario 1, PBO’s preferred scenario, the new policy changes would result in an estimated $589-million increase in taxation revenues, $356 million or 60 per cent of which would go to the federal government. Families in Ontario would pay $224 million more in federal taxes, close to 63 per cent of the total. More than 95 per cent of additional federal tax payable would come from families with family taxable income above $150,000.

Table S-1 Increase in federal and provincial tax revenues (2018-2019)

	($ M)
Scenario 1	
∆ Federal revenue	356
∆ Provincial revenue	233
Total	**589**
Scenario 2	
∆ Federal revenue	262
∆ Provincial revenue	173
Total	**435**
Scenario 3	
∆ Federal revenue	659
∆ Provincial revenue	412
Total	**1,071**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

Table S-2 presents a comparison of our five-year revenue profile of scenario 1 (our preferred estimate) with the profile presented by Finance Canada in its 2018 Budget (Table B-1 in Appendix B presents the revenue profile of the other scenarios).

PBO's revenue profile is, on average, $186 million (90 per cent) higher per year, than Finance Canada's estimate.

Table S-2 Comparison of PBO's five-year revenue profile with Finance Canada's

Increase in federal tax revenues ($ M)	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
PBO (scenario 1)	356	374	393	410	429
Finance Canada	190	200	205	215	220
Difference	**166**	**174**	**188**	**195**	**209**

Sources: Statistics Canada's linked LAD, T2, T4 and T5 database, Parliamentary Budget Officer and Finance Canada.

Overall, we have identified about 33,000 families who could be impacted by the Government's measures to restrict income sprinkling. In general, these families are likely to have a household taxable income of more than $150,000 and have a male controlling owner. They would also likely reside in Ontario or Alberta[3], and in an urban area with a population of more than 100,000 (Table S-3).

Table S-3 Characteristics of families potentially affected by income sprinkling policy changes

Characteristic of affected families	Increase in federal tax payable ($M)	No. of families	Share of total (%) Increase in federal tax payable	Share of total (%) Affected families
Total affected families	**356**	**32,900**	**100**	**100**
Family income over $500K	116	5,600	32	17
Family income over $150K	345	29,300	97	89
Ontario	224	17,100	63	52
Alberta	46	4,900	13	15
Quebec	23	4,100	7	12
Other provinces	63	6,800	18	21
Urban area, 100,000+	298	26,500	84	80
Male controlling owner	250	21,900	70	67
Female controlling owner	106	11,000	30	33

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

Note: Family income refers to family taxable income

1. Introduction

1.1. July 18 Proposal

On July 18, 2017, the Minister of Finance announced consultations on three policy proposals developed to address tax planning strategies involving the use of private corporations.

These strategies included "sprinkling" corporate income to family members; pursuing long-term "passive" investments within a corporation; and methods to convert regular corporate earnings into capital gains.

In the week of October 16, 2017, the Government indicated its intention "to simplify the proposal to limit the ability of owners of private corporations to lower their personal income taxes by sprinkling their income to family members who do not contribute to the business".[4]

On December 13, 2017, the Minister presented his simplified proposal, which gave more details on the nature of the reasonableness test. He provided specific situations in which dividends paid to family members would not be considered split income.[5] Budget 2018 confirmed the application of the new rules as laid out in the December 2017 proposal. These new rules have come into effect January 1st, 2018.

This report analyzes the proposed changes to address income sprinkling,[6] also known as income splitting. This term refers to the ability of a high-income owner of a Canadian-controlled private corporation (CCPC) to arrange the ownership structure of a corporation in order to distribute some of its profits to family members in lower tax brackets. This would have the impact of reducing the family's overall tax liability.

The proposed changes revolve mainly around extending the current TOSI rules.[7] Under the current rules, certain types of income received by minor children (those aged 17 and under) are taxed at the top personal tax rate and personal tax credits (apart from the dividend tax credit) are not allowed.

The types of income targeted by the current TOSI rules are dividends from private corporations, as well as income from a trust or partnership derived from a business operation of a related individual.

The proposed extensions of the TOSI rules in July's discussion paper were as follows:

- **Extending the meaning of "specified individual"** so that adults receiving split income could also be targeted by the TOSI.

- **Introduce a reasonableness test** for adults receiving split income so that TOSI rules apply only to those who did not contribute meaningfully to the business. The reasonableness test would be different if the individual is aged between 18 and 24, or 25 and over.
- **Introduce a connected individual test** to determine whether income received by a specified individual is split income. An individual who exerts control or some degree of influence over a corporation would be considered connected to that corporation. Thus, adult family members of the connected individual who are receiving income from the corporation would need to pass the reasonableness test to avoid the application of the TOSI.
- **Extend the definition of "split income"** to include:
    - Income from certain types of debt obligations;
    - Gains from the disposition of property, the income from which is split income; and,
    - For specified individuals aged 24 and under, income (that is, compound income) on property consisting of the proceeds from income previously subject to the TOSI rules or the attribution rules.[8]

1.2. December 13 Clarifications

The December 13, 2017, announcement presented specific situations in which dividends paid to family members would not be considered as sprinkling income, and thus would not be affected by the extended TOSI rules. It also provided some thresholds in terms of labour and capital contributions.

Specified individuals aged 18 to 24 would be required to provide a greater labour contribution, as they would have to be actively engaged on a regular, continuous and substantial basis in the activities of the business.

On the other hand, individuals aged 25 and over would only need to be involved in the activities of the business (that is, they contributed labour that could have otherwise been remunerated by way of salary or wages).

"Actively engaged in the activities of the business" is defined as working on average at least 20 hours per week during the part of the year in which the business is operational. This average of 20 hours per week must have taken place during the current year, or a combination of any five previous years.[9]

If this criterion is met, any dividend received from the family business in which the individual was actively engaged is excluded from the new TOSI rules. This would apply only in the year in which the individual was actively engaged if he or she has not yet reached five years of active engagement.

For children aged 18 to 24, the active labour contribution is the only way to completely exclude all the dividends received from the new TOSI rules. For any family member aged 25 and over, the same exclusion will prevail if they work at least 20 hours per week on average in the current year or any five previous years.

However, even if they don't reach the 20-hour threshold, they can still receive a reasonable amount of dividend based on the labour contribution they will have provided and the TOSI will apply only on the unreasonable excess.

The same applies for capital contributions, as a legislatively-prescribed maximum return on the assets contributed by the individual would be imposed for those aged 18 to 24. On the other hand, individuals aged 25 and over would only be required to have contributed assets or assumed risk in support of the business.

The December announcement provided a further way of excluding dividends from the extended TOSI rules. Indeed, if a family member aged 25 and over owns at least 10 per cent of the shares of the family CCPC (in terms of votes and value), and if that corporation earns less than 90 per cent of its income from the service sector and is not a professional corporation, then all dividends received are excluded from the new rules.

Furthermore, for family members aged 25 and over, TOSI will apply only in cases where it is evident that an amount received is disproportionate relative to the contributions. The new rules will also not apply to the spouse of a CCPC owner aged 65 and over, to align with existing tax law which allows pension income splitting for seniors.

Finally, the December announcement also made some additional changes to the initial proposal. Here are the most important with regards to our costing exercise:

- The definition of "related individual" will not be extended to an aunt, uncle, nephew or niece unlike what was initially intended in July's proposals.
- The Government will not proceed with the proposed measures to apply the TOSI to compound income (that is, income earned from the investment of an initial amount of income that is subject to the TOSI or attribution rules).
- A person inheriting property will generally not face a less favourable treatment than the deceased.

2. Methodology

2.1. Data

The analysis in this report is based on a data linkage between corporate income tax returns (T2) of CCPCs and personal income tax returns (T1) of their owners. It also links T4 (salaries) and T5 slips (dividends) to the CCPCs that issued them and the individuals who received the amounts.

This linked database was built for the 2012 to 2014 tax years, based on the previous works of Wolfson et al. (2016) and Wolfson and Legree (2015), which used a similar database with data up to 2011.[10]

The dataset is built from a subsample of the Longitudinal Administrative Databank (LAD)[11] where only CCPC owners[12] and their family members[13] were kept. The LAD is a 20 per cent sample of the T1 Family File (T1FF), which contains the universe of individual tax filers.

Family members, not sampled in the LAD, of CCPC owners in the LAD are extracted from the T1FF and merged into our dataset. Finally, another dataset containing all the T4 and T5 slips emitted by the CCPCs owned by individuals in the LAD to their family members is merged with our dataset.

2.2. Principal and Secondary CCPC Owners

As a first step, we use the linked database to establish a hierarchy of ownership for each family-owned CCPC. Potential tax savings from sprinkling dividend income from a family-owned CCPC require that family members who are CCPC owners would be in different tax brackets if T5 dividend income is excluded.[14]

Therefore, we attempt to identify the primary controlling owner in each family. The family member meeting the following criteria is assumed to be the primary owner:

1. Owns a minimum of 10 per cent of the shares of at least one family-owned CCPC (from schedule 50 of the T2);
2. Has the highest taxable income in the given tax year among family members who are CCPC owners; and
3. Is not a child, an ex-spouse or a deceased person.

Family members who have received dividends from a CCPC, but do not meet all the criteria above, are considered to be secondary owners. For the purposes of our income sprinkling analysis, we assume that primary owners allocate dividends to certain secondary owners to achieve tax savings.

2.3. Identifying Families Affected

The main challenge in assessing the revenue impact is to determine who will be affected by the extension of the TOSI rules. One of the difficulties lies in the lack of data on hours of work.[15]

Indeed, individuals who have worked on average at least 20 hours a week in the CCPC during the year, or during any combination of five previous years, will be excluded from the extension of the TOSI rules.

Since the tax data we use do not contain hours of work, we can only present scenarios. For example, it is assumed that full-time students would not have enough time to work 20 hours a week, on average.

We do have data from the T4 slips of family members who received employment income from a family-owned CCPC. Thus, we can use these data to approximate the number of individuals who could have possibly worked more than 20 hours per week during the year and exclude them from the application of the new rules.

However, there is no way for us to know how many individuals have already accumulated five years of working more than 20 hours per week on average, and thus would be excluded from the new rules, even if they did not work in the family CCPC during the year.

Because we cannot clearly identify the individuals who will be subject to the TOSI rules, we have computed possible revenue outcomes for the Government based on three different scenarios.

Scenario 1 presents our preferred estimate, while scenarios 2 and 3 offer possible lower and upper limits for the revenue estimate.[16]

In all three scenarios, we have considered dividends paid to adult family members as not being subject to the TOSI, for individuals where:

- the employment income based on the T4 slip issued by a family owned-CCPC was above a $15,000 threshold;[17]
- if they were aged 25 or older, they owned at least 10 per cent of the shares of a family-owned CCPC that was not in the service or professional sector; [18,19]
- they were the spouse of a primary owner aged 65 or over.

Note that we considered children aged 18 to 24 who were full-time students for at least eight months during the year as being subject to the TOSI, even if they had salary income from the CCPC above the $15,000 threshold.[20]

Scenario 1

In this scenario, we also excluded all the spouses aged 25 and over from being subject to the new TOSI rules. The rationale behind this scenario is that it is likely that most spouses have assumed some risk in the family business (for example, using the house as collateral for a bank loan to start the business). Therefore, we assume they would pass the reasonableness test and see the dividends they received as being exempt from the TOSI. This is our preferred scenario.

Scenario 2

This scenario is similar to scenario 1, but we also excluded all children aged 25 and over from being subject to the new TOSI rules. Thus, we assume they have provided some level of labour and/or capital contribution that would be sufficient to pass the reasonableness test.

Scenario 3

This scenario is also similar to the first one. However, we exclude only spouses of primary business owners outside the professional sector. The rationale is that in some professions, it is possible that the spouse is not assuming risk with respect to the business.[21]

In all the aforementioned scenarios, we are missing potential income splitting that could take place through family trusts. A certain number of CCPC owners set up family trusts, the beneficiaries of which are their children. These trusts can own shares of the CCPC and receive dividends distributed on those shares.

The new TOSI rules will also apply to income flowed through the trust in the hands of family members who would be subject to the new TOSI rules. However, our dataset does not contain any information with regards to trusts; thus, we are likely missing a large share of income splitting paid out through family trusts.

Finally, in certain cases the social insurance number or the business number was incomplete on the T2 schedule 50; thus, Statistics Canada could not establish the link of ownership. We are, therefore, probably missing other family members to whom income was possibly distributed.[22] These two issues represent an upside risk to our revenue estimate.

2.4. Revenue Impact

For each scenario presented in the previous section, we computed the change in the tax payable of each family assuming that dividends identified as split income were reallocated to the primary owner and included in his or her taxable income.[23]

This assumes an implicit behavioral response. The reason is that unless the primary owner is already taxed at the top personal income tax (PIT) rate, the family tax under this assumption should always be lower. It is most likely that owners of CCPCs who are not in the top bracket would stop paying dividends to family members who would be subject to the new TOSI rules.[24]

This is the only behavioral effect our analysis takes into consideration. Thus, a significant downward risk on our revenue estimate is that families with enough cash flow could decide to retain a higher proportion of earnings within the corporation rather than pay out dividends. We are unable to quantify the magnitude of this impact.

There are two additional downward risks to our revenue estimates. Family members who are currently somewhat engaged in the family business could increase their participation (that is, work more hours). On the other hand, family members aged 25 and over with less than 10 per cent of the shares of a family-owned CCPC could increase their stake in the family business in order to be excluded from the new rules.

It is not clear whether the impact of these downward risks would be greater than that of the upward risks stemming from the absence of data on trusts and on income from certain types of debt obligations. The net effect could be a revenue estimate that is slightly higher or lower.

Finally, our revenue estimates are based on 2014 tax data. However, we used 2018 tax parameters (PIT rates, income brackets, dividend tax credit rates, and so on) to compute the tax payable by each individual. We also scaled our estimates to 2018 using the growth rate in dividend payments to households.[25]

3. Revenue Estimates

Table 3-1 presents our estimates of the change to federal and provincial tax revenues under the three previously described scenarios for fiscal year 2018-2019. As expected, scenario 3 generates the highest increase in revenues, while scenario 2 the lowest.

We expect the actual value will lie closer to the result of scenario 1, but it could end up somewhere between the results of scenarios 2 and 3.

Under scenario 1, PBO's preferred scenario, the new policy changes would result in an estimated $589-million increase in taxation revenues, $356 million or 60 per cent of which would go to the federal government. Families in Ontario would pay $224 million more in federal taxes, close to 63 per cent of the total. More than 95 per cent of additional federal tax payable would come from families with family taxable income above $150,000.

We also notice that the increase in tax revenues is higher for the federal government. However, it is still significant for the provinces, as the increase in provincial revenues is around 65 per cent of the federal increase.

Table 3-1 Increase in federal and provincial tax revenues (2018-2019)

	($ M)
Scenario 1	
Δ Federal revenue	356
Δ Provincial revenue	233
Total	**589**
Scenario 2	
Δ Federal revenue	262
Δ Provincial revenue	173
Total	**435**
Scenario 3	
Δ Federal revenue	659
Δ Provincial revenue	412
Total	**1,071**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and PBO.

Tables 3-2 presents a comparison of our five-year revenue profile of scenario 1 (our preferred estimate) with the one presented by Finance Canada in its 2018 Budget.[26] PBO's amounts are indexed annually using its forecasted values of dividend payments to households.

PBO's revenue profile is, on average, $186 million (90 per cent) higher per year, than Finance Canada's estimate.

Table 3-2 Comparison of PBO's five-year revenue profile with Finance Canada's

Increase in federal tax revenues ($ M)	**2018-2019**	**2019-2020**	**2020-2021**	**2021-2022**	**2022-2023**
PBO (scenario 1)	356	374	393	410	429
Finance Canada	190	200	205	215	220
Difference	**166**	**174**	**188**	**195**	**209**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database, PBO and Finance Canada.

Table 3-3 shows a breakdown by province of the change in federal and provincial revenues for scenario 1. Ontario contributes the most to the increase in federal tax revenues, followed by Alberta, Manitoba and Quebec.

It is also evident that since Ontario has higher PIT rates (including its surtax) than some provinces, it accounts for a larger share of the increase in provincial revenues than in federal revenues (69 per cent vs 63 per cent). Similarly, British Columbia's contribution to the increase in federal revenues is slightly higher than half of Alberta's contribution, while the increase in provincial revenues is almost equal in both provinces.

Table 3-3 Increase in federal and provincial tax revenues by province[27]

	Increase in tax revenue ($M)		**% of total revenue increase**	
Province	**Federal**	**Provincial**	**Federal**	**Provincial**
Atlantic Provinces	5.5	3.2	1.5	1.4
Quebec	23.3	22.7	6.5	9.7
Ontario	224.1	160.0	62.9	68.6
Manitoba	25.9	10.1	7.3	4.3
Saskatchewan	5.9	2.4	1.6	1.0
Alberta	46.2	17.7	13.0	7.6
British Columbia	25.5	17.2	7.2	7.4
TOTAL	**356.4**	**231.5**	**100.0**	**100.0**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and PBO.

4. Distributional and Gender-based Analysis

PBO estimates that about 33,000 families could be affected by the income sprinkling legislation. Our distributional analysis is done at the family level, given the structure of our database. The number of affected families is lower than the number of CCPCs, since some families own more than one CCPC.

In general, we estimate that these families affected are likely to have a household taxable income of more than $150,000 and a male controlling owner. They are also likely to reside in Ontario or Alberta, and in an urban area with a population of more than 100,000.

The results in this section are based on the assumptions from Scenario 1, the central scenario for our revenue estimate. The distributional and gender-based analysis provided in this section are broadly consistent across other scenarios.

4.1. Family Taxable Income

We estimate that the owners of these CCPC(s) split over $2.4 billion in dividends and could face a total of $356 million in additional federal taxes payable under the policy changes (Table 4-1).

More than 90 per cent of additional federal tax payable would come from families with family taxable income of between $150,000 and $1 million.

Table 4-1 Families affected by family taxable income

				Share of total (%)		
Family taxable income range	**Increase in federal tax payable ($M)**	**Potential split dividends ($M)**	**No. of families**	**Increase in federal tax payable**	**Split dividends**	**Affected families**
Up to $100K	2	28	900	1	1	3
$100K to $150K	9	94	2,700	3	4	8
$150K to $250K	47	401	8,700	13	17	26
$250K to $500K	182	1,154	15,000	51	47	46
$500K to $1M	99	566	4,800	28	23	15
> $1M	17	189	800	5	8	2
Total	**356**	**2,432**	**32,900**	**100**	**100**	**100**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

4.2. Geography

PBO estimates that the tax incidence from the changes to limit income sprinkling would primarily affect families in Ontario and Alberta and particularly those in urban areas with a population of more than 100,000 people.

In addition, we estimate that families in Ontario would pay 63 per cent of the additional federal taxes payable, while those in Alberta would pay 13 per cent, and British Colombia, Manitoba and Quebec 7 per cent (Table 4-2).[28]

This could reflect the degree to which income sprinkling arrangements have been facilitated under different provincial tax regimes, or it could reflect other provincial differences, such as the propensity of professionals to incorporate.[29]

In terms of families affected, we estimate that 52 per cent are in Ontario, 15 per cent in Alberta, 12 per cent in Quebec and 10 per cent in British Columbia (Table 4-2).

Table 4-2 Families affected by province

Province	Increase in federal tax payable ($M)	Potential split dividends ($M)	No. of families	Share of total (%) Increase in federal tax payable	Share of total (%) Split dividends	Share of total (%) Affected families
Atlantic Provinces	5	37	800	2	2	2
Quebec	23	193	4,100	7	8	12
Ontario	224	1,468	17,100	63	60	52
Manitoba	26	168	1,900	7	7	6
Saskatchewan	6	45	800	2	2	2
Alberta	46	333	4,900	13	14	15
British Columbia	26	191	3,200	7	8	10
	356	**2,432**	**32,900**	**100**	**100**	**100**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

Note: Figures may not add up due to rounding.

Looking at area size[30], we estimate that about 84 per cent of tax payable and 80 per cent of families affected reside in urban areas with a population of more than 100,000 (Table 4-3).

Table 4-3 Families affected by area population

Area population	Increase in federal tax payable ($M)	No. of families	Share of total (%) Increase in federal tax payable	Share of total (%) Affected families
Urban area, 500,000+	227	19,900	64	60
Urban area, 100,000 - 499,999	70	6,600	20	20
Urban area, 30,000 - 99,999	18	1,800	5	5
Urban area 15,000 - 29,999	10	1,000	3	3
Urban area 1,000 - 14,9999	27	3,200	8	10
Rural area, less than 1,000	3	500	1	2
Total	**356**	**32,900**	**100**	**100**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and PBO.

Note: Figures may not add up due to rounding.

4.3. Sex of controlling owner

We estimate that roughly two-thirds of families who could be impacted by the new income sprinkling policy changes have a male controlling owner for the family-owned CCPC(s) (Table 4-4). This would also be, by our definition, the highest income earner in the family. The share of male controlling owners rises for families with higher taxable income.

Table 4-4 Families affected by taxable income (male controlling owner)

				Male share of total (%)		
Taxable income range	**Increase in federal tax payable ($M)**	**Potential split dividends ($M)**	**No. of families**	**Increase in federal tax payable**	**Split dividends**	**Affected families**
Up to $100K	1	16	500	53	59	56
$100K to $150K	5	54	1,600	58	57	59
$150K to $250K	29	240	5,400	62	60	62
$250K to $500K	127	781	10,200	69	68	68
$500K to $1M	73	406	3,500	74	72	73
> $1M	15	162	700	87	86	88
Total	**250**	**1,659**	**21,900**	**70**	**68**	**67**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

Table 4-5 provides a breakdown of affected families whose CCPC(s) have a female controlling owner; we estimate women represent just under one-third of owners of affected CCPCs.

Table 4-5 Families affected by taxable income (female controlling owner)

Taxable income range	Increase in federal tax payable ($M)	Potential split dividends ($M)	No. of families	Female share of total (%)		
				Increase in federal tax payable	Split dividends	Affected families
Up to $100K	1	11	400	47	41	44
$100K to $150K	4	40	1,100	42	43	41
$150K to $250K	18	161	3,300	38	40	38
$250K to $500K	56	373	4,800	31	32	32
$500K to $1M	26	160	1,300	26	28	27
> $1M	2	27	100	13	14	13
Total	**106**	**773**	**11,000**	**30**	**32**	**33**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and Parliamentary Budget Officer.

Appendix A

In this report, we computed the change in the tax payable of each family assuming dividends identified as split income were reallocated to the primary owner and included in his or her taxable income. Table A-1 below presents a comparison of the revenue estimates under this assumption and the alternative where dividends continue to be paid out to the same family members, but the amounts we identified as split income are subject to taxation at the top personal income tax (PIT) rate as per the new TOSI rules.

As can be seen in the first column, the revenue increase under the alternate assumption is generally 30 per cent higher at the federal level and almost 70 per cent higher at the provincial level. This difference occurs because some controlling owners of CCPCs are not already in the top tax bracket. They would pay lower tax if they distributed the dividends to themselves (the reallocation scenario) instead of paying them out to family members who will be subject to TOSI.

Table A-1 Increase in federal and provincial tax revenues: Split income subject to TOSI vs reallocated to controlling owner (2018-2019)

($ M)	**Subject to TOSI**	**Reallocated**
Scenario 1		
∆ Federal revenue	459	356
∆ Provincial revenue	396	233
Total	**855**	**589**
Scenario 2		
∆ Federal revenue	336	262
∆ Provincial revenue	282	173
Total	**618**	**435**
Scenario 3		
∆ Federal revenue	836	659
∆ Provincial revenue	698	412
Total	**1,534**	**1,071**

Sources: Statistics Canada linked LAD, T2, T4 and T5 database and PBO.

Appendix B

Table B-1 Federal and provincial five-year revenue profiles for each scenario

Increase in tax revenues ($ M)	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
Scenario 1					
Federal Government	356	374	393	410	429
Provincial Governments	233	245	257	268	281
Total scenario 1	**589**	**619**	**650**	**678**	**710**
Scenario 2					
Federal Government	262	275	289	301	315
Provincial Governments	173	181	190	199	208
Total scenario 2	**435**	**456**	**479**	**500**	**523**
Scenario 3					
Federal Government	659	692	726	757	793
Provincial Governments	412	432	453	473	495
Total scenario 3	**1,071**	**1,124**	**1,179**	**1,230**	**1,288**

References

Wolfson and Legree (2015). Private Companies, Professionals, and Income Splitting—Recent Canadian Experience. Canadian Tax Journal, Volume 63, Issue 3. Retrieved from: https://www.ctf.ca/ctfweb/CMDownload.aspx?ContentKey=cd00aa06-98e3-4c5c-a3af-68395a23e90a&ContentItemKey=e6749e0f-aa60-4a8f-8cdc-cccdcc2eb220.

Wolfson, Veall, Brooks and Murphy (2016). Piercing the Veil: Private Corporations and the Income of the Affluent. Canadian Tax Journal, Volume 64, Issue 1. Retrieved from: http://www.ctf.ca/ctfweb/Custom/CMDownload.aspx?ContentKey=14151034-8af2-41f6-8f57-3f4da1e9c13e&ContentItemKey=4347208f-fe38-4b39-8777-119c5b5a4b30

Notes

1. See: https://www.fin.gc.ca/n17/17-066-eng.asp
2. See page 45 of Budget 2018 Tax Measures: Supplementary Information. Available at: https://www.budget.gc.ca/2018/docs/tm-mf/tax-measures-mesures-fiscales-2018-en.pdf
3. The provincial distribution, particularly the relatively high concentration of impacted families in Ontario, is sensitive to our assumption to exclude potential dividend sprinkling with spouses from our central scenario. Under scenario three which includes some spouses, Ontario's share of tax payable and families fall to 52 per cent and 44 per cent respectively.
4. See: http://www.fin.gc.ca/n17/17-097-eng.asp
5. See: https://www.fin.gc.ca/n17/data/17-124_1-eng.asp
6. On November 23 2017, PBO published a report analysing the proposed changes to the taxation of corporate passive investment income. See: http://www.pbo-dpb.gc.ca/en/blog/news/Changes_to_Taxation_of_CPII
7. The tax on split income (TOSI) was introduced in the 1999 federal budget after the *Neuman* case (*Neuman v. The Queen*, 1998 SCC) and is set out in section 120.4 of the *Income Tax Act*.
8. Finance Canada (2017) p. 27. Some additional changes are also proposed in the consultation paper, such as considering an individual's split income for the eligibility of income-tested benefits. We did not assess the impact of these additional changes on government's revenue.
9. According to Finance Canada's documents, the five previous years don't have to be consecutive.
10. PBO accessed this data through Statistics Canada's Canadian Centre for Data Development and Economic Research (CDER) program under a Memorandum of Understanding. Numbers, figures and tables in this report containing analytical results produced using the linked database are explicitly sourced as such. They have been vetted for confidentiality by Statistics Canada officials.
11. See: http://www23.statcan.gc.ca/imdb/p2SV.pl?Function=getSurvey&SDDS=4107
12. A CCPC owner is defined as an individual listed on the T2 Schedule 50 of at least one CCPC. When corporations fill Schedule 50, they are only required to identify shareholders who own at least 10 per cent of the shares of the corporation.
13. Statistics Canada uses the census family definition. This includes couples and their children (whatever the age of the children) living in the same dwelling. Grandchildren living with their grandparent(s) but with no parents present

also constitute a census family. See: http://www23.statcan.gc.ca/imdb/p3Var.pl?Function=Unit&Id=32746

14. As mentioned in section 1.1, the new rules would extend the definition of “split income” to include income from certain types of debt obligations. Because we only have data on dividends paid by family owned CCPCs, we limited our analysis to this type of income. This represents an upward risk to our estimate of the revenue increase for the government.

15. For example, the reasonableness test could be based in part on the labour contribution supplied by the specified individual, in terms of hours of work. However, the current tax data we used for our analysis do not indicate the amount of labour supplied by an individual in terms of hours.

16. In our analysis, we only kept families where the change in total tax payable (federal + provincial) was greater than a $1,000 threshold. Because there are set-up costs involved in incorporating a business, we don’t believe families under that threshold would engage in income splitting for tax purposes. Removing this threshold modifies the revenue estimates by less than 1 per cent.

17. The $15,000 threshold corresponds to someone working at an hourly wage of $15 for 20 hours a week during 50 weeks. This proxy for the active labour contribution in the CCPC will obviously cause our simulations to exempt from the new rules family members paid at a higher wage that did not work on average 20 hours per week during the year. Similarly, it will consider family members working at a lower wage (for example at the minimum wage of $11 an hour in New Brunswick) or in a family business that is not in operation all year long as being subject to the new rules even if they did work on average more than 20 hours per week. We also miss individuals who may have dedicated more than 20 hours per week to the family CCPC and received only dividends as a payment rather than salary. We did a sensitivity analysis using thresholds of $10,000 and $20,000, but the results changed by less than 1.5 per cent.

18. The dataset generated by Statistics Canada provide the six-digit North American Industry Classification System (NAICS) code of the top five CCPCs directly owned by each individual in the LAD. This top five is in terms of retained earnings multiplied by the percentage of ownership of the individual. We used the lowest NAICS code across each family as being the sector of all the CCPCs owned by that family in order to avoid having shareholders of a holding company (NAICS code 55) owning shares of an operating corporation in the manufacturing sector (NAICS code 31) to be considered in the service sector (which would have subjected them to the new rules). Because we only have NAICS code of directly owned CCPCs, we could consider a family to own exclusively CCPCs in the service sector if all the shares of the operating company are held indirectly.

19. Professionals refer to: lawyers and notaries (NAICS 5411), accountants (NAICS 5412), veterinarians (NAICS 54194), physicians (NAICS 6211), dentists (NAICS 6212) and chiropractors (NAICS 62131).

20. We identified full-time students as having an education deduction (LAD variable “edudci”) of $3,720 or higher. This corresponds to a monthly amount of $465 for each month enrolled as a full-time student multiplied by

eight months. We assume that full-time students would not have enough time to work at least 20 hours per week on average in the family CCPC. We did a sensitivity analysis using amounts of $2,790 and $5,580 (corresponding to six months and 12 months of full-time studies respectively), but the results barely changed (we observed changes of less than 0.5 per cent).

21. In some provinces, non-professional family members are not allowed to hold shares in a professional corporation. However, they may be permitted to hold shares of a management or other type of corporation that provides services to the professional corporation.

22. Because the database we used is built using census families, we are possibly missing income splitting taking place with adult children not living at the same address as their parents.

23. Table A-1 in the appendix presents the revenue estimates under the assumption that dividends continue to be paid out to the same family members, but the amounts we identified as split income are subject to taxation at the top personal income tax (PIT) rate as per the new TOSI rules.

24. In certain circumstances, the primary owner may still wish to pay dividends to family members in lower tax brackets even if those dividends will be subject to the TOSI and thus taxed at the top PIT rate. For example, the receiving family member could invest the after-tax income received and the resulting investment income will be taxed at the lower PIT rate faced by that family member. The Department of Finance initially wanted to also subject compound income to the TOSI, but the December 13, 2017 announcement indicated it had abandoned this idea.

25. We used the variable "Households: Net Property Income" (v62305966 from CANSIM table 380-0072) from the Current Account which contains dividend payments to households. The quarterly historical values were used until 2017Q2, and we used our in-house forecasting model for the values up until 2023 in our five year profile.

26. See page 75 of Budget 2018. Available at: https://www.budget.gc.ca/2018/docs/plan/budget-2018-en.pdf

27. For confidentiality purposes, Newfoundland and Labrador, Prince Edward Island, New Brunswick and Nova Scotia are reported under Atlantic provinces, because some counts were too low for Statistics Canada to release the data. For the same reason, the territories were excluded from the table.

28. See endnote 3.

29. For example, Wolfson & Legree (2015) suggest that policy changes in the 2005 Ontario Budget which allowed doctor's family members to own non-voting CCPC shares contributed to stronger growth in dividend sprinkling and incorporation in that province.

30. We use the area size code variable ("asr__i") from the LAD.