

To: The Honourable Bill Morneau, Minister of Finance

From: Waterloo Centre for Taxation in a Global Economy, University of Waterloo

Date: October 2, 2017

Subject: Comments on Proposed Changes to the Taxation of Private Corporations

Overview

We, the members of the (University of) Waterloo Centre for Taxation in a Global Economy (Tax Centre), would like to provide feedback that is relevant to the changes to anti-income-splitting (income sprinkling) rules proposed by the Department of Finance on July 18, 2017. Specifically, we provide a critical analysis of all published academic research, authored by members of the Tax Centre and by others, that documents the degree of income splitting in Canada and studies the impact of anti-income-splitting rules on taxpayer behaviour.

The three studies that examine the degree of income splitting in Canada (in order of our discussion below) are:

- Schuetze, H. J. 2006. Income splitting among the self-employed. *Canadian Journal of Economics* 39(4): 1195-1220.
- Wolfson, M., and S. Legree. 2015. Private companies, professionals and income-splitting – recent Canadian experience. *Canadian Tax Journal* 63(3): 717-737.
- Macnaughton, A., and T. Matthews. 1999. Is the income-splitting tax needed? Some empirical evidence. *Canadian Tax Journal* 47(5): 1164-1179.

The only study that examines the impact of anti-splitting rules on behaviour is:

- Bauer, A. M., A. Macnaughton, and A. Sen. 2015. Income splitting and anti-avoidance legislation: evidence from the Canadian “kiddie tax”. *International Tax and Public Finance* 22(6): 909-931.

Two of the authors of these studies, Andrew Bauer and Alan Macnaughton, are members of the Centre and co-authors of this brief.

Schuetze (2006)

One method of illegal income splitting among the self-employed is paying a salary to one's spouse even though no work is done. This study develops a way of estimating the prevalence of this practice and the consequent loss of tax revenue. In particular, the employment rate of wives in Canada is significantly higher for wives whose husbands are self-employed¹ than for wives whose husbands are employed: 79.6 percent versus 72.9 percent. One interpretation of this difference is that 6.7 percent (79.6 - 72.9) of wives whose husbands are self-employed are being paid even though they do no work in the business. However, non-tax reasons could explain this difference in the employment rate. For example, a wife may be more likely to work when her

¹ For the purposes of this study, the self-employed include people who operate a business through a corporation.

husband is self-employed in order to gain access to the health and dental benefits that are a common part of employee compensation packages, but are not generally available to the self-employed. Another possibility is simply the ease and flexibility of working in the family business whereas seeking independent employment is relatively more onerous.

A way to separate the tax and non-tax factors for the difference in employment rates is to compare Canadian and U.S. data. In the United States, there is no tax incentive to pay a spouse for non-existent work because couples file joint tax returns; with taxation being based on the sum of the two spouses' incomes, paying a salary to reduce the husband's income and increase the wife's income (or vice versa) has no effect on tax. Therefore, if the difference in employment rates in Canada is partially tax-driven, the difference in employment rates in the United States should be smaller. Schuetze (2006) finds this to be the case: while the employment rate of wives with self-employed husbands in the U.S. is again higher than the rate for those whose husbands are employed (74.2 percent versus 72.6 percent), the difference between the two rates is much smaller than the Canadian difference—1.6 percent versus 6.7 percent.

After using statistical means (regression equations) to control for the possibility that the two categories of wives differ on other dimensions, the author calculates that 1 in 18 self-employed husbands in Canada may have been engaged in this form of illegal income splitting in 1998. This represents an annual revenue loss of \$500 million. The good news in the study, if there is any, is that the prevalence of income splitting seems to have declined from a rate of 1 in 10 in the late 1980s and early 1990s. The study attributes this to the decline over time in the number of single-income couples.

The study found no evidence of self-employed women in Canada engaging in income splitting with their husbands. The explanation offered was that there is likely little net advantage to this, given the husbands' greater amount of labour force attachment (i.e., they would not have low income).

The importance of the Schuetze study is that it is the only one that is able to estimate the prevalence of income splitting through wage and salary payments to family members. However, since there were no policy measures attempting to influence the degree of income splitting in the time period studied, it is not possible to directly examine how taxpayers might react to such legislation. Also, this study is based on data that is almost 20 years old; however, it might be possible for Department of Finance staff to replicate Schuetze's work with more recent data. One would expect to find a lower amount of income splitting today than Schuetze found in 1998 on the basis that the number of single-income couples has continued to decline.

Wolfson and Legree (2015)

This study develops a database that links Canadian-controlled private corporations (CCPCs) to their owners. It is thus able to examine the amount of dividends and salaries paid to these owners. Further, it is able to examine the amount of dividends and salaries paid to family members of these owners. The matching of CCPCs to their owners is not perfect, but it is the only research that has been able to do this at all. The data is for 2011.

Using assumptions to infer who the controlling owners were, the paper estimates that \$18 billion of dividends was paid to controlling owners of CCPCs, and \$6 billion of dividends was paid to other family members of such owners. Also, \$31 billion of wages and salaries was paid to controlling owners of CCPCs, and \$11 billion of wages and salaries was paid to family members of such owners. Thus, for every dollar of these two types of income that was paid to controlling owners of CCPCs, about 33 cents was paid to their family members. While assumptions were needed to classify payments, these figures appear to be derived from a sound methodology, and appear to be quite believable.

The study proceeds from these data to a much more interesting but methodologically challenging analysis of the amount of income splitting that is achieved by paying salaries to family members in excess of the fair market value of services rendered. Their procedure is to multiply the \$11 billion of wages and salaries paid to family members by an assumed proportion that the fair market value payment is of the total wages paid (“*number 1*” below). Further, to convert this excess-salary amount into a revenue cost (i.e., the reduction of federal and provincial tax), they multiply by the percentage points of difference between the effective marginal tax rate of the owner and the effective marginal tax rate of the family member (“*number 2*” below).

This would be an appropriate methodology if these two numbers were known. However, the paper does not estimate these numbers using any of their data. Instead, for *number 1*, the paper simply refers to “a general sense that such salaries are often overstated in order to benefit from income splitting”, points to one newspaper article that might or might not be suggesting there is evasion, and displays a table which assumes that the proportion of salaries that is paid for income-splitting purposes is 10 percent, 30 percent or 50 percent. It would appear that the authors’ preferred figure is 30 percent. As for *number 2*, which the authors could have – but did not – determine from their data, the authors seem to prefer a figure of 5 percentage points. No reason is offered for not examining the effective marginal tax rate of CCPC owners versus the effective marginal tax rate of owners’ family members. One is left to infer that the researchers simply lacked the budget to do this, since it is a crucial step in establishing the validity of their assumptions, and hence their results.

The difficulty with the methodology used in the paper to measure the revenue cost of salary-based income splitting is that if the true value of *number 1* is zero (perhaps because some owners overpay family members while other underpay), the amount of income splitting would be zero, and the revenue cost of the splitting would be zero. Similarly, if the true value of *number 2* is zero, the amount of income splitting would similarly be zero. In short, although one would reasonably expect income splitting in this setting, the authors do not *prove* that there is any income splitting at all. They state that there is income splitting for tax purposes and then compute a number based on largely unsupported assumptions. Employment income received by family members could be fair compensation for labour services rendered.

A similar procedure was used to measure the revenue cost of income splitting using dividends: the amount of dividend income paid to family members (\$6 billion) was multiplied by *number 2* above. This implies that all dividend income paid to family members is paid for income-splitting purposes; none of it is fair compensation for services rendered, capital contributed, or risks

borne.² The upward bias of this assumption for the revenue cost is clear, but the appropriate assumption to use instead is less clear.

The later part of the paper provides information on the trend in the number of restaurant private corporations, lawyer private corporations, and physician private corporations in the period from 2001 to 2011. Consider Ontario as an example. Although the right of professionals to incorporate in Ontario was legislated in 2001, further changes in 2005 allowed family members (i.e., non-members of the profession) to acquire non-voting shares in most such corporations; for lawyers, family members can own non-voting shares in connected CCPCs. The article shows that the rise in professional CCPCs owned by doctors and physicians increased dramatically in Ontario after 2005, and also increased to some degree for lawyers. Yet the trend remained relatively flat for restaurant owners in Ontario and other parts of Canada.³ The authors conclude that the most likely explanation for this spike in professional corporations, particularly for physicians, is the opportunity to split dividend income with family members. However, other factors may contribute meaningfully. Limited liability, which attracts many people to the corporate form, would appear not to apply to Ontario professional corporations. Nevertheless, the Department of Finance might consider whether a more complete analysis of this data would help to understand the influence of income splitting incentives relative to other factors.

Macnaughton and Matthews (1999)

This study examines the pattern of dividend income and net business income reported by minor children between 1986 and 1996, based on data released by the Canada Revenue Agency. In this period, minors' dividend income increased by five times (from \$51 million to \$253 million) and minors' net business income increased by three times (from \$18 million to \$62 million), despite the fact that there is no discernible time trend in the amounts of such income received by individuals aged 20-24. If one thinks of minors as being the group most likely to receive income for income-splitting purposes, and the 20-24 group as being less subject to these influences, then it would appear that income splitting increased dramatically in that 10-year period.

This study shares the drawback of Wolfson and Legree (2015) in that it has no way to say whether amounts received by minors were received for the purposes of income splitting. However, while Wolfson and Legree look at all family members together, Macnaughton and Matthews examine minors on their own. It is much easier to imagine that a spouse might receive income as a result of labour and capital contributions than it is to imagine a minor receiving income on those grounds. Also, Macnaughton and Matthews' observation of a trend over time of increased receipts by minors, which are believed to be commonly used for income-splitting purposes, coincides with a period over which there were taxpayer-friendly court decisions on income-splitting and, based on casual empiricism, increased publicity on income splitting.

² Table 2 of the study is the total revenue cost from income splitting, including components from both dividends and salaries.

³ The increase for lawyers after 2005 in Canada shows an upward trend, but the article argues that this trend results primarily from federal legislation allowing individual lawyers within a professional corporation to claim an individual (rather than shared) small business deduction (SBD). The ability to do this has been reduced by measures against SBD multiplication included in the 2016 budget.

Wolfson and Legree, in contrast, are limited to a single data point per entity – 2011. On the other hand, Macnaughton and Matthews are unable to tell whether the source of the income is a CCPC or a public corporation, while Wolfson and Legree know that the income they study is from CCPCs.

Bauer, Macnaughton and Sen (2015)

This study uses similar data to that employed by Macnaughton and Matthews, but with the time period changed. Specifically, the authors examine the share that different age groups have of aggregate dividend income and capital gains income from 1997 to 2009, adjusted for changes in the size of different age groups in the population. The purpose of examining this period is that the tax on split income (TOSI, also known as the “kiddie tax”) began in 2000. It is difficult to conceive of non-tax reasons why this share should change dramatically over time. Thus, the paper attributes to the policy change the 86 percent decline in the share of dividends reported by minor children, corresponding to \$1.5 billion less in dividend income for this group between 2000 and 2009. One way to interpret this finding is that perhaps 14 percent of the pre-2000 dividends received by minors was for non-tax reasons, and 86 percent was for income splitting. Thus, the paper estimates both the prevalence of income splitting and the effectiveness of one particular rule in stopping it. The paper is like Schuetze (2006) in that it has a convincing way to measure the prevalence of income splitting, and it also has a way to measure the effect of one policy instrument.

A second finding of this study is that the share of capital gains (income not covered by the legislation at this time) increases by 70 percent in the post-TOSI period, suggesting that parents are switching to an alternative income-splitting technique. However, this percentage effect is on a small base (i.e., there was little capital gains income received by minors in the pre-TOSI period), and thus the decrease in dividend income is much larger than the increase in capital gains income. Put another way, the estimated reduction in minors’ taxable dividend income was \$1.5 billion, while the estimated increase in minors’ taxable capital gains income was just \$62 million; potential revenue declines by only 4 percent.

A third finding of the study is that the share of dividends reported by non-minor children increases by 88 percent in the post-TOSI period. However, as this amount is also related to the decrease in dividend share reported by minor children, the authors were unable to compute a more complete estimate of the revenue impact of this behavior. Altogether, although it might be thought that cracking down on one form of income splitting just creates an equal and offsetting effect of increases in other forms of income splitting, this was not what was observed when comparing these three primary findings. Undesirable side effects were created by the anti-avoidance measure but, for those effects the authors were able to measure empirically, the effects were relatively minor.

Of course, larger effects might have been felt after the end of the sample period; the government extended the TOSI to certain types of capital gains in 2011, and to certain types of business and rental income in 2014. Moreover, the upward trend in non-minor dividend income is at the heart

of the Department of Finance's proposed rules. It would be worthwhile to use more recent data to study effects of the TOSI on these types of income and taxpayers.

Concluding Observations

Taken together, these 4 studies provide convincing evidence that income splitting has been an issue for the Canadian tax system for a considerable time period. In a system that taxes at an individual unit level, this behaviour is inevitable. The publicly available evidence is that income splitting has been found in dividend income, capital gains income, labour income, and net business income. More broadly, accounting academic research has demonstrated clearly that taxpayers trade off the costs and benefits of tax planning as they structure their business and personal decisions. To the extent that strong tax incentives exist for income splitting, or for retaining income in private corporations, taxpayers will respond to that incentive. Large sample empirical analyses with good data allow researchers to help estimate the responses to particular measures or features of the taxpayer.

The more difficult question to answer is the effect of policy responses on taxpayers' income-splitting behaviour. One study, Bauer, Macnaughton and Sen (2015), provides evidence that policy responses can be effective, and that secondary effects (whereby income splitting is achieved by other means) are small. However, the policy response studied by that article – the TOSI – contained no “primary purpose” clause or other judgement-based exceptions for special cases. The government's July proposals provide for a reasonableness test for dividend recipients over age 24, and thus it is unclear whether the success of the TOSI in reducing income splitting (as it has been implemented up to now) will extend to its new configuration.

We would also note that the July 18 proposals provide that the TOSI would continue to not apply to income received by an individual as salary or wages. Schuetze (2006) provides fairly convincing evidence that there is a problem in this area. Wolfson and Legree (2015) show that there are very large payments to family members of CCPC owners, and thus this problem could be of some significance (even if one discounts their particular estimates of the degree of income splitting of this type). Of course, none of this literature provides any indication of what type of policy response might be successful in attacking this problem, or whether the increase in complexity and compliance cost would outweigh the benefits.

About the Tax Centre

The Waterloo Centre for Taxation in a Global Economy is part of the School of Accounting and Finance at the University of Waterloo. The Centre's main objectives are to support academic research focussed on taxation in our global economy and to disseminate that knowledge to tax professionals in corporations, governments and the intermediaries between the two. The Centre also raises the standard of tax education in Canada through collaboration between tax academics and those who employ tax professionals. For further information on the Tax Centre, please visit <https://uwaterloo.ca/school-of-accounting-and-finance/waterloo-centre-taxation-global-economy>, or contact the Tax Centre's Director, Kenneth Klassen, PhD, FCPA, FCA, kklassen@uwaterloo.ca.