BACKGROUNDER

Income Sprinkling Using Private Corporations

The Government of Canada is committed to an economy that works for the middle class, and those working hard to join it. Canada's economy is growing faster than it has in over a decade, with over 400,000 jobs created in the last two years. All Canadians deserve to benefit from economic growth. The Government has lowered taxes for middle class Canadians and is committed to ensuring that unintended advantages are not being realized by high-income and wealthy individuals.

The next step in the Government's plan for the economy is to address tax planning strategies using private corporations. These strategies encourage high-income and wealthy individuals to incorporate, so they can get a lower tax rate than wage earners and many middle class Canadians. In July 2017, the Government released a consultation paper with proposals to address these strategies, and has engaged Canadians in an open dialogue on a way forward.

By insisting on greater tax fairness, the Government can lower the federal small business tax rate to 9 per cent from 11 per cent in 2015 (10.5 per cent today, 10 per cent effective January 1, 2018 and 9 per cent January 1, 2019), knowing that the support we provide for Canada's small businesses – including the lowest small business tax rate in the G7 – will help create more jobs and grow the economy.

In response to concerns raised by Canadians who contributed to the consultation, the Government will be making changes to simplify the proposal to address income sprinkling, a strategy that can be used by high-income owners of Canadian-controlled private corporations (CCPCs) to lower their personal income taxes by sprinkling their income among family members who do not contribute to the business. Only an estimated 50,000 family-owned private businesses are sprinkling income. This represents only a small fraction - around 3 per cent – of CCPC owners. Businesses with family members who meaningfully contribute to the business will not be impacted. In addition, the Government will not be moving forward with the measures that would limit access to the Lifetime Capital Gains Exemption.

Income Sprinkling – Who's Affected?

- The vast majority of private corporations are not implicated. It is estimated that about 50,000 family-owned corporations benefit annually from income sprinkling. This represents only a small fraction – roughly 3 per cent – of Canadian controlled private corporations.
- About 80 per cent of these families earn more than $125,000 in total income; 50 per cent of these families earned more than $200,000 in total income.

Family businesses will be unaffected if the spouse or adult children are meaningfully contributing to the business.

Private corporations can be used by some to gain a tax advantage to reduce tax obligations by shifting income to family members in a lower tax bracket who are not contributing to a business. Individuals earning income directly cannot do this. The Government believes this is unfair. The proposed measures on income sprinkling will address this inequity in a manner that does not prevent compensation of family members for genuine contributions to a business.

Sprinkling Income Using a Private Corporation – Owners of Corporations with Exactly the Same Income but One Owner Pays $21,000 More in Tax

Alicia and Brent are neighbours and business owners living in Nova Scotia.

- Alicia is a single mother with two children under the age of 18.
- Brent has a spouse and two children, ages 19 and 21; none of these family members has income.

Alicia's household pays about $21,000 more tax than Brent's household under current rules.

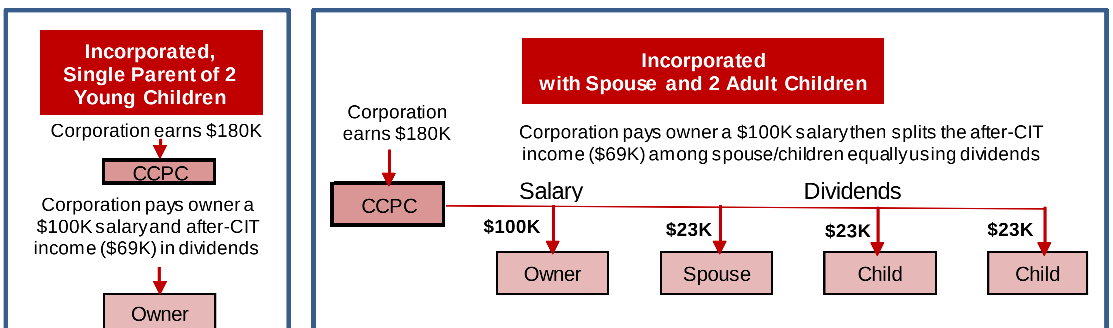
Both Alicia and Brent have incorporated businesses that earn $180,000 before salary and taxes in 2017. Each receives $100,000 in salary, and the remaining after-tax profits are paid out as dividends.

The difference is that Alicia's corporation pays all of the dividends to her. Total taxes (corporate income taxes plus personal income taxes) add up to $63,600 for Alicia's household.

Brent's spouse and adult children have no involvement in the business. They own shares in the corporation, for which they paid very little. Brent's corporation pays the remaining after-tax profits in equal amounts to these three family members as dividends. Total taxes paid by Brent's household equal $42,600.

Overall, Alicia's household pays $21,000 more in taxes (roughly 50 per cent) than the amount paid by Brent's household.

Under the proposed rules, given that Brent's family members do not contribute to his business, any dividends they receive would be taxed at higher marginal rates such that there would be no tax benefit to paying dividends to Brent's family members. Brent could therefore decide to have all salary and dividends paid to him. As a result, his household would pay roughly the same amount of tax as Alicia's household.



	Single parent: Owner	Spouse/adult children: CCPC	Owner	Spouse	Child	Child
Federal CIT (10.5%)	8.4	8.4	n/a	n/a	n/a	n/a
Provincial CIT (3%)	2.4	2.4	n/a	n/a	n/a	n/a
Federal PIT	28.0	n/a	16.5	0.0	0.0	0.0
Provincial PIT	24.8	n/a	13.1	0.7	0.7	0.7
Total tax	**63.6**	**42.6**				
Average tax rate	**35%**	**24%**				

Tax parameters for 2017. Dollar amounts in thousands unless stated.

Through income sprinkling, high-income individuals can (depending on family circumstances) save several thousands of dollars in taxes in a given year. For instance, an individual earning $300,000, with a spouse and two children over the age of 18 that are not contributing to the business and who do not have other income, can, in some circumstances, reduce his or her income tax by $48,400 per year – roughly equivalent to the income of the average Canadian.

Sprinkling Income Using a Private Corporation – Owner Sprinkles Income to Family Members and Saves $48,400, As Much as an Average Canadian Earns in a Year

Richard lives in Ontario with his spouse and two adult children who have no income.

Richard has an incorporated business that earns $300,000 before taxes and salary in 2017. He owns the voting shares in the corporation. Richard's spouse and two children, ages 18 and 20, have no involvement in the business. They own shares in the corporation, for which they paid very little.

The corporation pays Richard $150,000 in salary. If all of the remaining after-tax profits were paid to Richard as a dividend, about $122,200 in total taxes (corporate income tax plus personal income tax) would be paid by Richard's household.

However, Richard's corporation is able to pay the remaining after-tax profits in equal amounts to his spouse and children as dividends. If this were done, then the total tax bill for their household would be reduced to $73,800 – for total tax savings of approximately $48,400 by using the private corporation to sprinkle income. This is as much as the average Canadian earns in an entire year.

Under the proposed rules, given that Richard's family members do not contribute to his business, any dividends they receive would be taxed at higher marginal rates such that there would be no tax benefit to paying dividends to his family members.

The Government intends to move forward with measures to limit income sprinkling using private corporations, while ensuring that the rules will not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members.

Specifically, the Government will introduce reasonableness tests for adult family members aged 18-24, as well as those 25 and older. These adults will be asked to demonstrate their contribution to the business based on four basic principles – whether they have made a contribution through any combination of the following:

- Labour contributions;
- Capital or equity contributions to the business;
- Taken on financial risks of the business, such as co-signing a loan or other debt; and/or
- Past contributions in respect to previous labour, capital or risks.

Throughout the consultation period the Government received feedback on the complexity of the proposed measures and potential unintended consequences. The Government also received feedback that the measures could create uncertainty in relation to how amounts received from a family business would be taxed. To address these concerns, the Government will simplify the proposed measures with the aim of providing greater certainty for family members who contribute to a family business. Specifically, the Government will work to reduce the compliance burden with respect to establishing the contributions of spouses and family members including labour, capital, risk and past contributions, better target the proposed rules, and address double taxation concerns.

Sprinkling Income Using a Private Corporation – Genuine Family Business Arrangements Not Affected

Jacob owns a family farm in southwestern Ontario which he works with his wife Frieda and their adult son Herman. The farm is incorporated and earns $120,000 in net business income before salary.

- The farm pays Jacob $65,000 in salary and dividends.
- The farm pays Frieda, who does the farm's accounting and helps out on the farm, $30,000 in salary and dividends.
- Herman, who is 25 years old and works on the farm during the summer, on weekends and during breaks from university, receives $17,500 in salary and dividends.

This family will not be affected by the proposed rules on dividend income sprinkling because dividend allocations to Frieda and Herman are reasonable compensation for their contributions to the farm.

- Once the small business tax reductions are fully implemented, the business will save an additional $750 which could be used to help pay for new farm equipment.

Lifetime Capital Gains Exemption

A number of contributors to the consultation have identified potential unintended consequences associated with the proposed measures to address the multiplication of the Lifetime Capital Gains Exemption (LCGE). For example, concerns were raised on the potential impact on intergenerational transfers of family businesses. Based on this feedback, the Government will not be moving forward with measures that limit access to the LCGE.

Next Steps

Taking into account the submissions made to the consultation, later this fall the Government will release revised draft legislative proposals outlining the proposed changes, which will be effective for the 2018 and subsequent taxation years.