GRAHAM SCOTT ENNS LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

P. 519-633-0700 · F. 519-633-7009
450 Sunset Drive, St. Thomas, ON N5R 5V1

P. 519-773-9265 · F. 519-773-9683
25 John Street South, Aylmer, ON N5H 2C1

www.grahamscottenns.com

Income Sprinkling, What's the Fuss?

Background

The headlines are being dominated daily with stories about income sprinkling. The government says it is a tax loophole being abused by the wealthy and they intend to stop it, but the rules they have proposed will impact low income individuals disproportionately. The opposition says the government is wrong but does not propose any solution and does not commit to the status quo. The other party(s) have no comment mainly to avoid siding with one side or the other and avoid disenfranchising followers. Canadians have now been pitted one against another, employees, vs. self employed vs. unionized workers vs. low income individuals vs. "the 1%" vs. public servants vs. the "middle class" vs. farmers vs. professionals such as Doctors, Dentists, lawyers and yes even yours truly the humble accountant who is bent on exploiting every loophole in the Income Tax Act. So, what is income sprinkling and why do some people think it is bad and some people think it is fair?

To try and understand the issue we need to understand some basics. The Income Tax Act does not dictate how to do business but rather what the tax is on income. So, when someone earns a dollar, the Income Tax Act lays out how much tax is paid on that dollar. The Act is also written in a manner that promotes the concept of integration, so that no matter how one earns the dollar, they pay the same amount of tax, roughly.

I often read columns and articles calling for a flat tax rate. In fact, there is a flat tax rate and it is much higher that the average person realizes. For Federal income tax purposes, anyone with taxable income greater than $202,800 is taxed at a flat rate of 33% on every dollar earned above that amount. With Provincial tax levies, although it varies among the Provinces and territories, the combined "flat" tax rate is around 50%. In Ontario where we are located the rate is more like 52% on income over $202,800 and 54% on income over $220,000. Put another way everyone who makes less than $202,800 pays a lower rate of tax than the maximum. People with very little income pay virtually no tax and the amount of tax progresses up to the $202,800 level. This flat tax rate in Ontario has been increased by approximately 6% in a very short time between the increase from 29% to 33% on the Federal tax side launched immediately upon election of the current government as well as the increases to the Provincial income tax rates at the income level above $220,000 over the last few years. Similar increases have occurred in other Provinces.

Income sprinkling is another way of saying a taxpayer is taking advantage of the fact that a lower rate of tax is being paid on income under $202,800 for Income Tax purposes. There are many ways to accomplish this goal. Some of the more popular are by way of dividends on shares of a private company, through wages or salaries and by generating second generation

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income on income currently taxed at the highest rates under the current rules designed to penalize those undertaking income sprinkling with individuals under the age of 18 which came into effect in 1999. Although the headlines would have you believe that your local family doctor is the main abuser of this system, in fact the ability to income sprinkle is restricted in certain jurisdictions such as Ontario under the various corporation acts such that many of the so called wealthy individuals who have been labeled loophole abusers, such as lawyers and accountants are restricted by corporate law from income sprinkling, at least in Ontario. In fact, all private corporations, except for Professional Corporations, ranging from small mom and pop operations to large private corporations earning multimillions can income sprinkle if structured to do so and even under the new rules will be able to continue to do so where there is a benefit which is greater where the income levels are much higher. Therefore, one of the first things the government needs to realize is that the one size fits all tax laws no longer work. Only medical doctors, dentists and pharmacists even have the ability to income sprinkle in Ontario among Professionals. Also, it has been highlighted by the government that the number of Professional Corporations has multiplied exponentially in recent years just for the purpose of taking advantage of the so-called loopholes. However, the fact that prior to 10 to 15 years ago Professionals in Ontario and many other Provinces were not allowed to incorporate at all seems to have escaped the attention of the government along with the fact that for certain professionals the ability to incorporate and specifically to income sprinkle was used by the Province as a tool to reduce the need to increase the amounts paid to those professionals.

What is the Benefit?

So how much can my local family doctor/dentist/business owner benefit by income sprinkling? The answer of course depends on the circumstances, but let's take an average example that is somewhat consistent with the structure of modern families. Let's say that our example doctor has been in practice for a while, has paid off any substantial school debt accumulated, has 1 spouse and we will round up to two children from the average for simplicity. As well, we will say that the spouse is employable in a reasonable "middle class" job but chooses to work in the doctor's office instead so forgoes the ability to earn approximately $55,000 or more as a wage with no other benefits. The two children have graduated secondary school, have virtually no other income and are attending post secondary education. The doctor under the advice of their lawyer and accountant and in accordance with corporate law and applicable tax law incorporates their medical practice and adds their spouse and two children as shareholders in the appropriate manner. If that doctor earns a net profit of $350,000 after paying overhead costs and before paying the spouse then let's look at the tax differential vs. earning the $350,000 in an unincorporated manner. All calculations made using Ontario tax rates currently in force:

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Individual	Amount of income	Tax if not incorporated	Amount of dividend income from Income Sprinkling after paying corporate tax	Tax undertaking Income Sprinkling on a dividend basis
Doctor	$295,000	117,611	108,750	18,663
Spouse	$55,000	9,125	108,750	18,663
Child 1	Nil	Nil	40,000	450
Child 2	Nil	Nil	40,000	450
Corporate tax	Nil	Nil	n/a	52,500
Total	**$350,000**	**126,736**	**297,500**	**90,726**

A couple of things to consider under the tax if not incorporated scenario, both the doctor and their spouse are forced to pay into the Canada Pension Plan and likewise earn a future pension from the contributions. As well, the doctor receives a tax credit included in the above calculations for the tuition fees of the two children from post secondary education. Having been forced to pay tax on all earnings the doctor likely will have maximized contributions to RESP's and tax-free savings resulting in reductions of the overall tax position in amounts not quantified in this paper. As well, even though the spouses' earning potential is $55,000 the amount the doctor can pay and be eligible to deduct for tax purposes is restricted under current tax law to a "reasonable" amount. If the spouse only takes the place of a person who would make $30,000 then that is all that can be deducted without incurring a tax penalty. For the purposes of this calculation, $55,000 is assumed to be reasonable.

Under the Income sprinkling scenario, I have just used a simple example where each child is given a dividend of $40,000 from the company and the doctor and their spouse equally split the remainder of the income after corporate tax. Under this scenario the family is much less likely to take advantage of RESP grants and each child will not be eligible for GST credits and any applicable Provincial tax credits.

In both cases I have not considered the benefit of utilizing an RRSP, but it should be noted that under the income sprinkling scenario, neither the doctor nor their spouse could contribute. Now these numbers can be changed to some combination of salaries and dividends, some different amounts for the children's dividends, etc. but this illustrates what would likely be the most extreme example undertaken at this income level.

If the doctor only sprinkles income to the spouse and not the children, the following is the result:

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Individual	Amount of income	Tax if not incorporated	Amount of dividend income from Income Sprinkling after paying corporate tax	Tax undertaking Income Sprinkling on a dividend basis
Doctor	$295,000	117,611	148,750	30,766
Spouse	$55,000	9,125	148,750	33,374
Corporate tax	Nil	Nil	n/a	52,500
Total	**$350,000**	**126,736**	**297,500**	**116,640**

This is a very real scenario not only for doctors but for most taxpayers we encounter at the income level noted or lower as people simply do not want to put significant sums into the hands of their other family members. As you can see the resulting tax savings is much less than portrayed in the media.

What Happens if the new rules as Announced Apply?

If the new rules as announced were applied to the same scenario the following would be the results:

Individual	Amount of income	Tax if not incorporated	Amount of dividend income from Income Sprinkling after paying corporate tax	Tax undertaking Income Sprinkling on a dividend basis with the new rules applying
Doctor	$295,000	118,088	108,750	18,936
Spouse	$55,000	9,223	108,750	49,264
Child 1	Nil	Nil	40,000	18,120
Child 2	Nil	Nil	40,000	18,120
Corporate tax	Nil	Nil	n/a	52,500
Total	**$350,000**	**127,311**	**297,500**	**156,940**

This result is clearly unfair as it is greater than the original amount of tax.

Another thing to consider is that the ability to income sprinkle creates an incentive to the parent to fund a child's education. A parent is under no obligation to fund a child's post secondary education. Also, from experience most people do not give out amounts to maximize the income

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splitting potential, at least at this type of income level and at least to children, simply because the money becomes the child's and the child is under no obligation to return any of it to the parent as the only way to return it is by way of gift. A bump in the amount of dividends being paid to individuals aged 18 – 24 compared to older age groups has been used by the government as another reason to suggest that the changes are urgent and that funding a child's education in a tax effective manner is an abuse of the system.

Conclusions

What can we conclude from the comments in this article?

- There would appear to be some benefit from income splitting at this income level, the benefit is multiplied if income can be split among more people,
- The amount of the benefit from income splitting is not anywhere near the amount that is being portrayed in the media and by the Prime Minister and the Minister of Finance, at least at this income level,
- The ability to income split provides an incentive to fund a child's education,
- The ability to income split provides an incentive to employ one's spouse,
- The ability to income split potentially reduces the dependence on the public pension CPP,
- The ability to income split reduces a family's reliance on RESP grants, Provincial education grants and loans and income tested tax credits meant for low income individuals, and
- The proposed rules constitute a significant penalty and do not simply make the family pay their "fair share" as if they had not undertaken the income splitting.

What About Very High Income – the 1%

Let's say that a wealthy individual shows up out of the blue at our accounting office and their annual income is $10 million. Lets also assume for the moment that as this is a new client and they have only ever reported their income as being self employed income and paid tax has been paid annually on the $10 million by one individual. Their annual tax therefore would be $5,320,395 including $5,128 of CPP contributions. The first $202,800 of this income is taxed at the lower rates and the remainder is taxed at the highest marginal rates.

In discussion with this new client it turns out that they are funding a large extended family from the after-tax earnings who otherwise have no income and are 18 years of age or older. So naturally a starting suggestion would be to simply spread the $10 million of income among 10 people rather than 1 to reduce the tax cost. Keep in mind this is a highly simplified example.

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What is the tax result of sprinkling this greater amount of income? Each individual will have a tax liability of $502,731 including $5,128 of CPP contributions. 10 people with this tax liability will be $5,027,310. If we remove the CPP component, the difference and hence the savings from income sprinkling becomes ($5,320,395 - $5,128) – ($5,027,310 – (10 times $5,128)) = $339,237.

I am not suggesting that this step is the only step a wealthy person would take to reduce income tax, however, the amount of the savings calculated as a percentage of the original $10 million of income is only 3.39%, whereas the tax savings to our original doctor at $350,000 of income was $36,010 or 10.3% so hence the impact of the proposed changes is much greater to a lower income person.

Conclusion on the High Income Scenario

My conclusion has been since the date of the announcement that if the proposed rules designed to eliminate the benefit of income sprinkling are in fact applied as proposed the lower your income the greater the increased tax will be as a percentage. In fact, other calculations I have prepared show that the tax increase is much greater on a percentage basis for even lower income individuals.

Next Step

Recent media releases suggest that there may be further amendments coming to the proposed tax rules (changes to the changes) and we are hoping that those changes will be made public in a reasonable time after the consultation period is up on October 2, 2017 in order that individuals may begin to plan and structure their affairs in accordance with the new rules. The other preferred alternative would be a delay to reconsider the proposed approach, but it does not seem as though the government plans to stop the process and go back to the drawing board.

The partners of this firm have submitted a letter directly to the Minister of Finance outlining our concerns with the application of the new rules and hope that the Minister at least takes the time to read it and understand. We also hope that the government will see fit to realize that the taxation of individuals should not be brought up to the highest common denominator, but rather lowered such that if employees are being taxed at too high a rate then their tax should be lowered.