

Presentation to
Senate Committee on National Finance: Study on the
Minister of Finance's proposed changes to the Income
Tax Act respecting the taxation of private corporations
and the tax planning strategies involved

Presented by

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Applied Research in Economics (CARE) Initiative

November 20, 2017
9:15 am to 10:00 am,
Salon C/D
Sheraton Newfoundland, St John's, NL

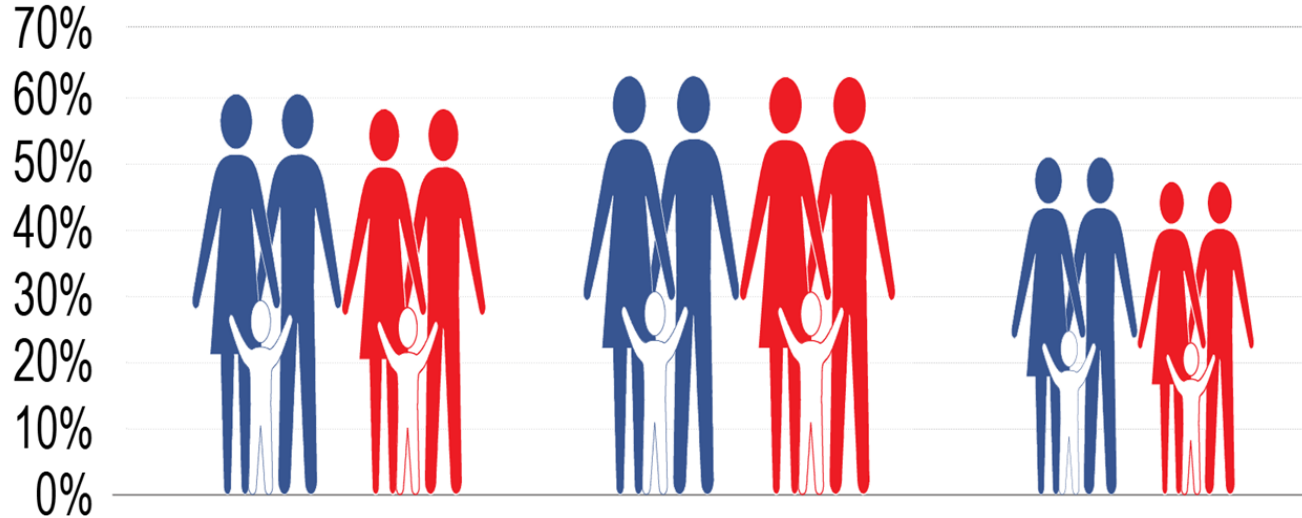
Outline

- We want to thank the Committee for allowing us to present our ideas on this important topic from the perspective of NL
- We understand that Finance Canada is attempting to address
 - Sprinkling income using private corporations (i.e., income splitting with family members)
 - Holding a passive investment portfolio inside a private corporation (i.e., using saving and investment strategies unavailable to others with similar income levels)
 - Converting a private corporation's regular income into capital gains

Hollowing Out?

Population Share

■ 2000 ■ 2014



NL: some hollowing
but strong
middle class!

CA: no hollowing
and strongest
middle class!

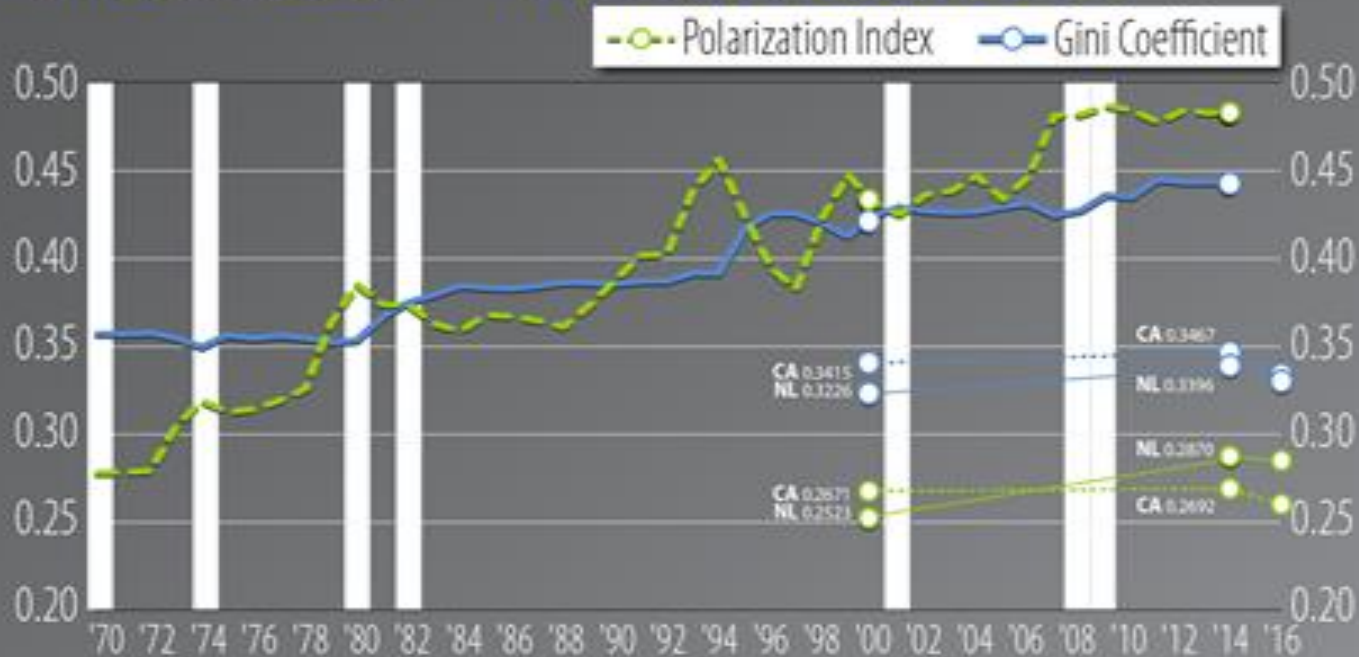
US: hollowing
and middle class
as a minority!

The middle class defined as population between 50% and 150% of the median equivalized family income. This is consistent with the IMF's definition.

Based on this definition, it does not appear that the middle class is shrinking in Canada and is shrinking only slightly in NL, but clearly income inequality is growing in the US and the size of their middle class is relatively much smaller

Polarization Index & Gini Coefficient

US: 1970-2014* NL and CA: 2000 & 2014**



* Underlying income data adjusted for household size using OECD's equivalence scale

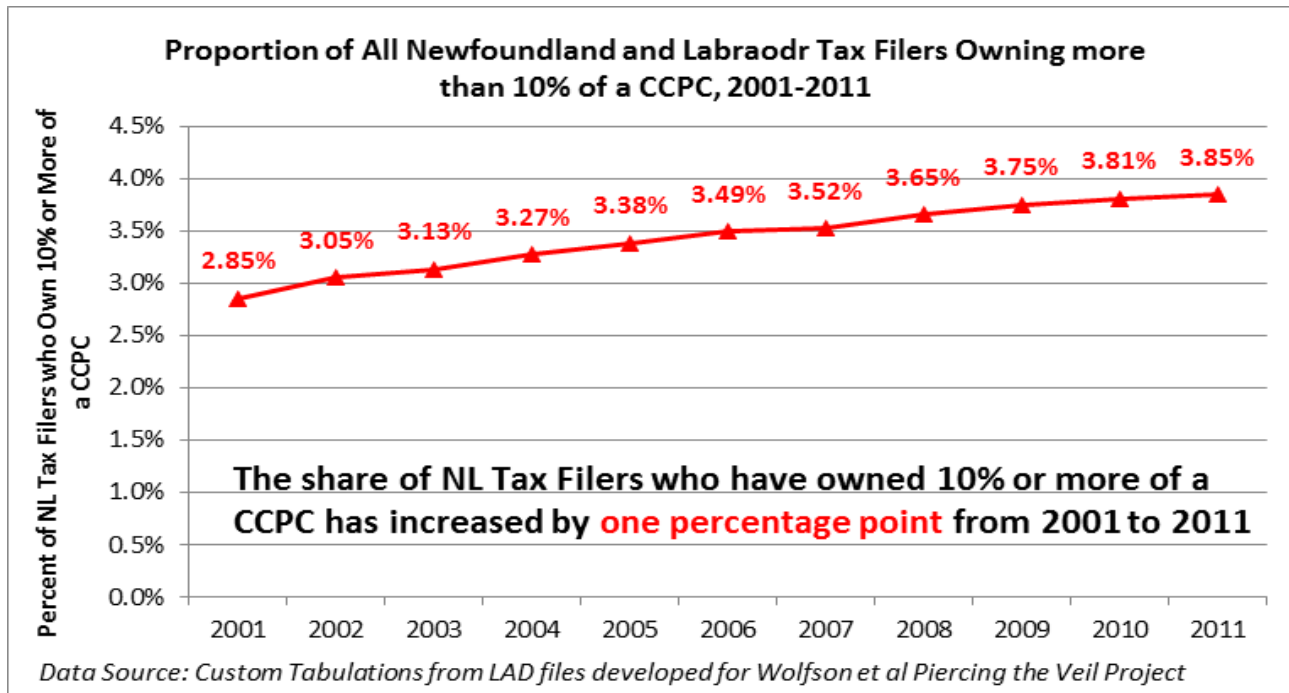
** Income adjusted (equivalized) based on number of individuals in household

Source: Current Population Survey and Statistics Canada's SPSSD/M

Based on modelling simulation for 2016, the lower polarization indexes and the lower Gini coefficients for Canada and NL indicate that the middle class must be growing in both jurisdictions for that years.

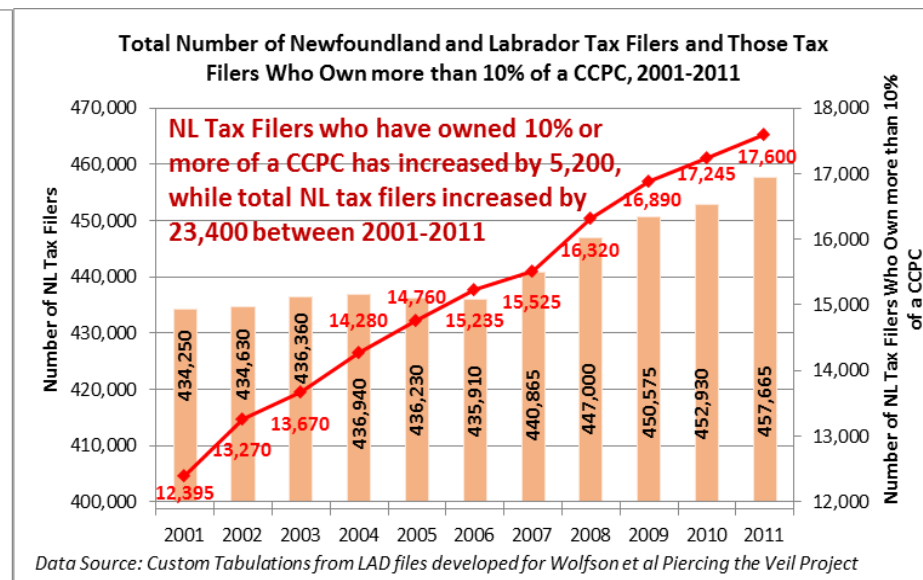
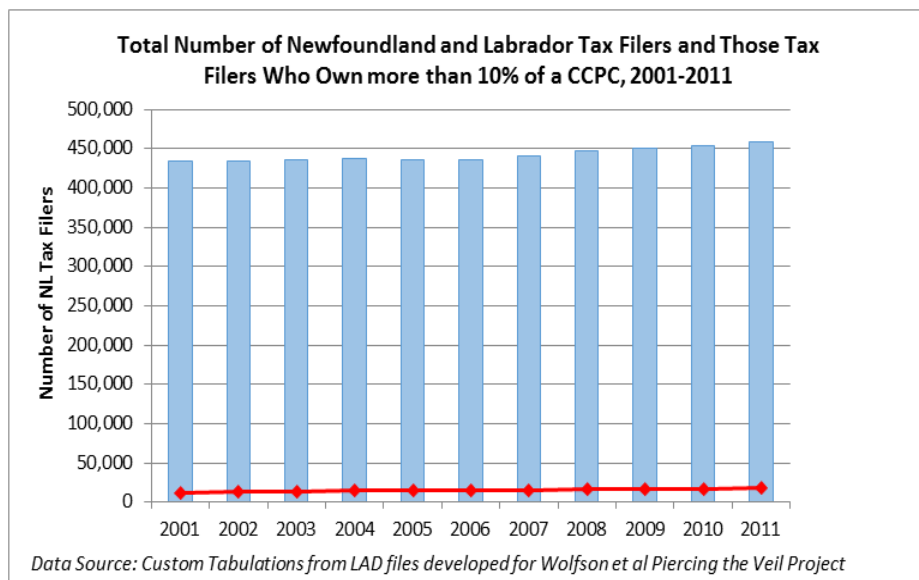
Therefore, it might require an additional explanation as to why these tax changes are currently being contemplated; rather than being part of a broader review of taxes.

NL Tax Filers and CCPC Ownership (1)



Over the eleven years for which my colleague and I have data, the proportion of NL tax filers who own 10 percent or more of a Canadian Controlled Private Corporation (CCPC) has only increased by one percentage point, but the rate of take-up appears to have increased after 2006 when the NL economy picked-up.

NL Tax Filers and CCPC Ownership (2)

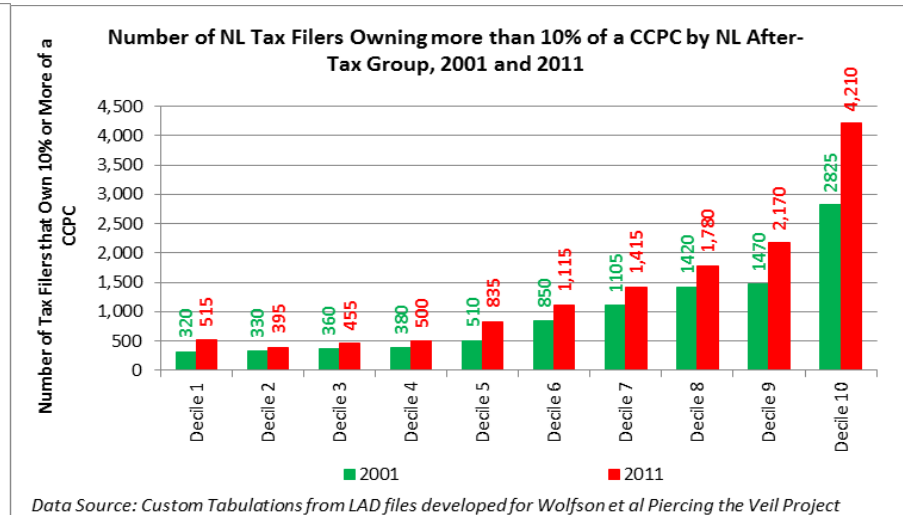
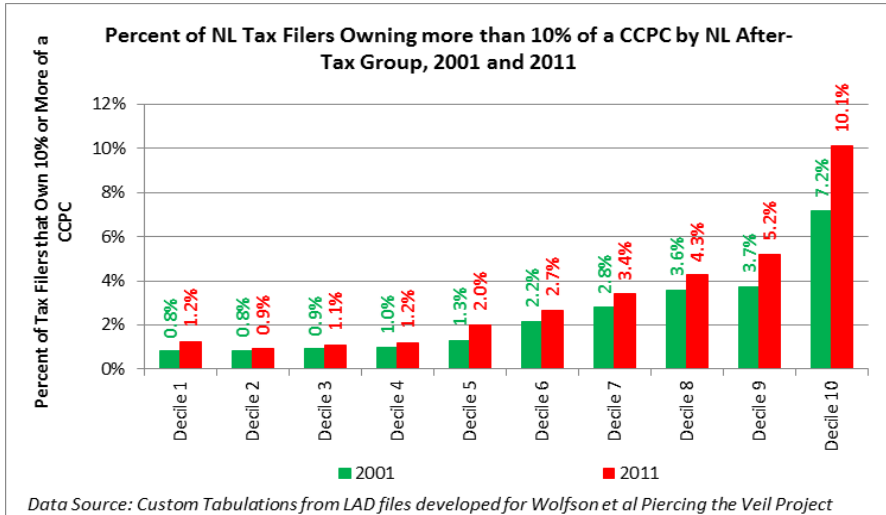


Over the eleven years, the number of NL tax filers who own 10 percent or more of a CCPC has increased from 12,395 tax filers (of 434,250 total tax filers) in 2001 to 17,600 tax filers (of 457,665 total tax filers) in 2011

For the bottom 90% of NL tax filers, only 1.90% owned 10% or more of CCPC in 2001. This increased to 2.45% in 2011, which lower than what Wolfson et. al. found for Canada

In the overall picture, the use of CCPC's does not appear to be an overwhelming problem in NL at this time

NL Tax Filers and CCPC Ownership – by Decile - T1 After-Tax Income Grouping

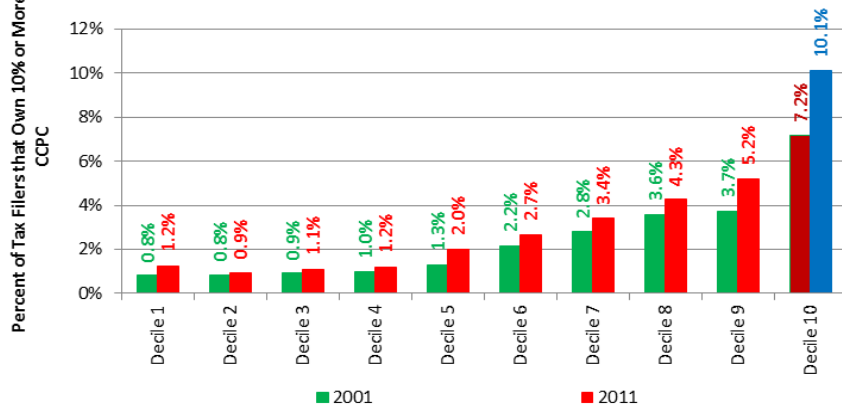


While the 10th decile income group has utilized this option more than others, over time all income groups are increasing their usage in both absolute and relative terms

Even though these diagrams illustrate that the higher after-tax income groups make more use of this option, a finer decomposition of the top after-tax income group will dramatically illustrate this point

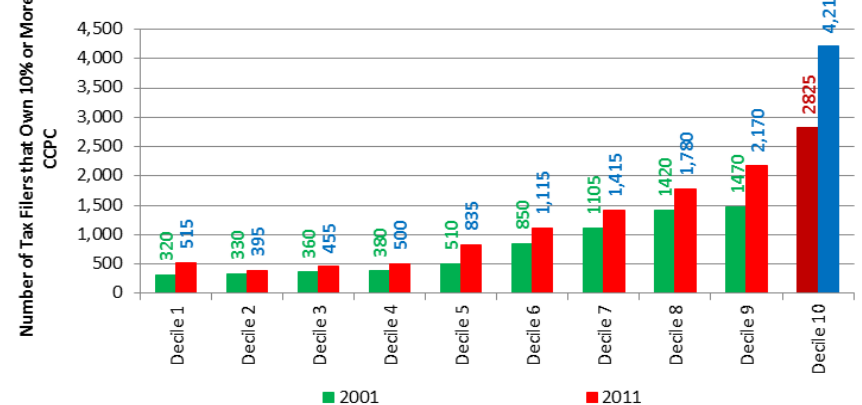
NL Tax Filers and CCPC Ownership – by Decile - T1 After-Tax Income Grouping

Percent of NL Tax Filers Owning more than 10% of a CCPC by NL After-Tax Group, 2001 and 2011



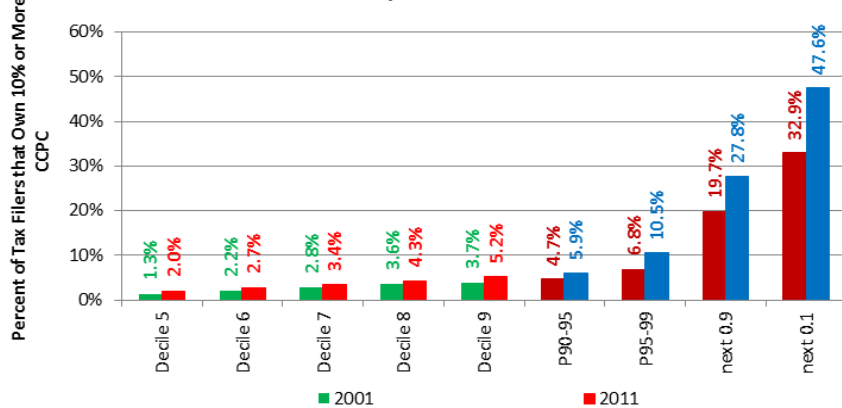
Data Source: Custom Tabulations from LAD files developed for Wolfson et al Piercing the Veil Project

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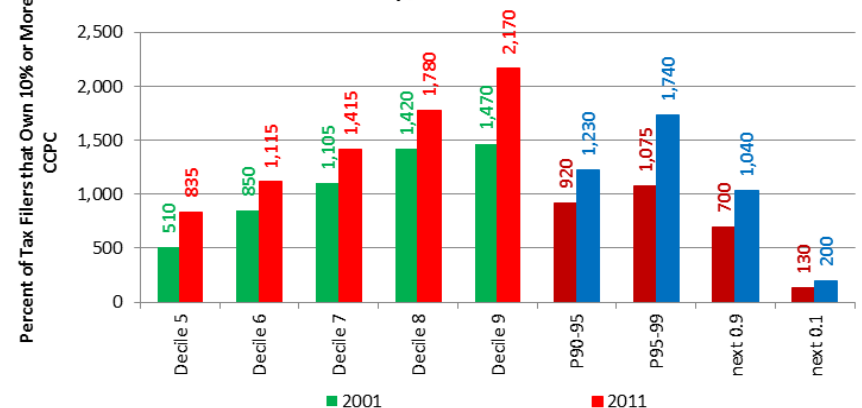
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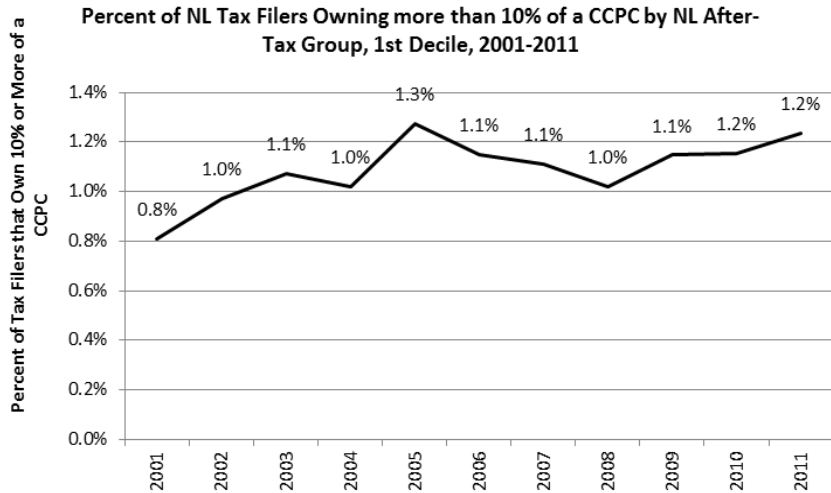
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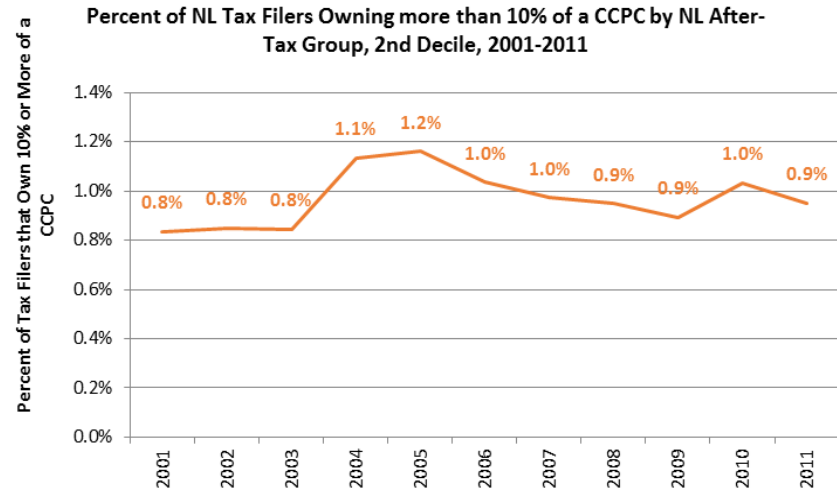
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The top one-tenth of one percent of after-tax income tax filers utilize the CCPC option most frequently, but they represent a very small number of tax filers (e.g., only 200 in 2011)! 8

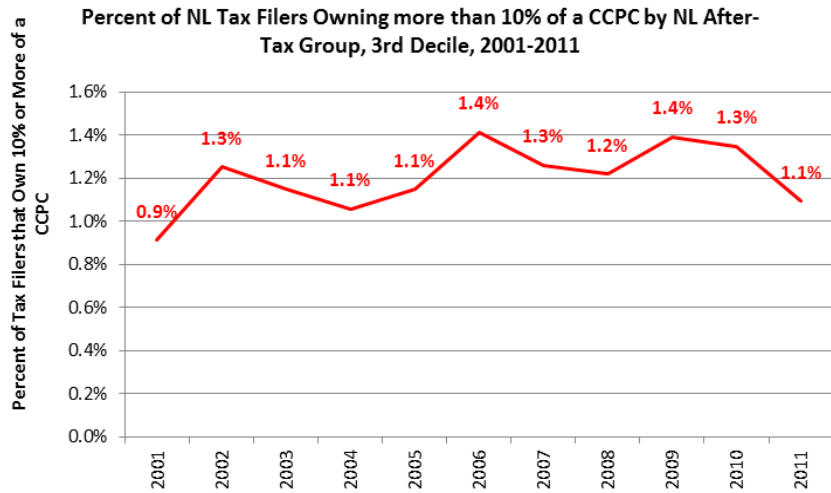
All Income Groups Take Advantage of the CCPC Option, but Higher Income Tax Filers Utilize it More (1)



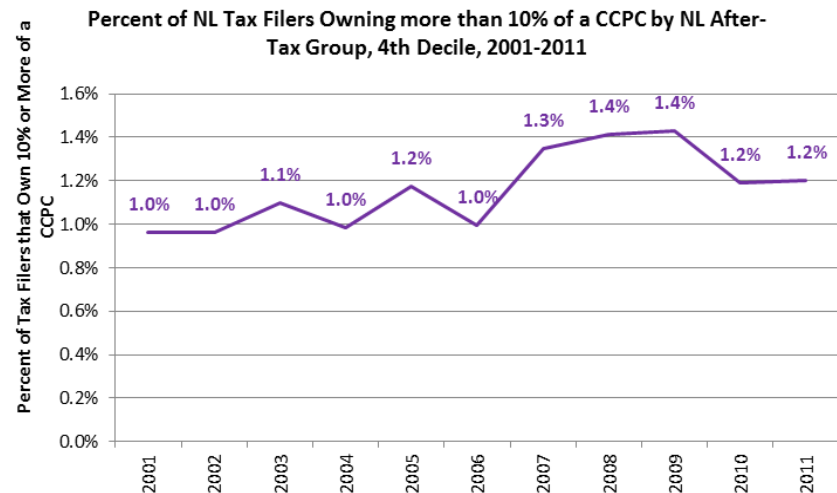
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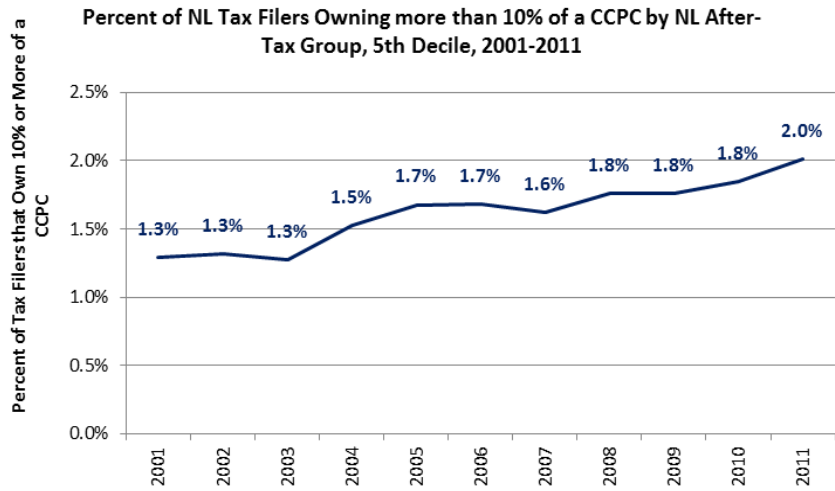


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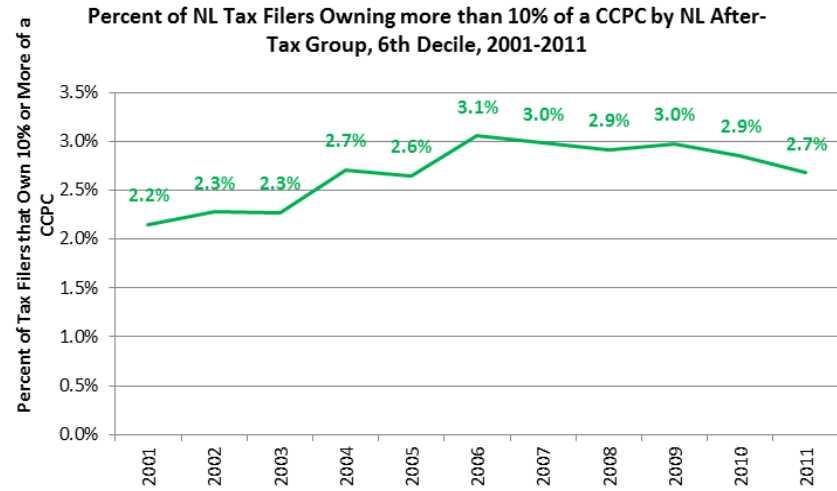


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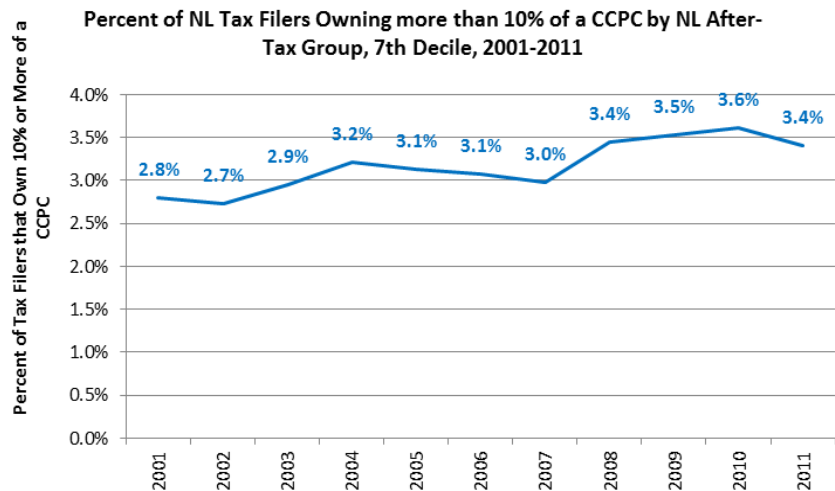
All Income Groups Take Advantage of the CCPC Option, but Higher Income Tax Filers Utilize it More (2)



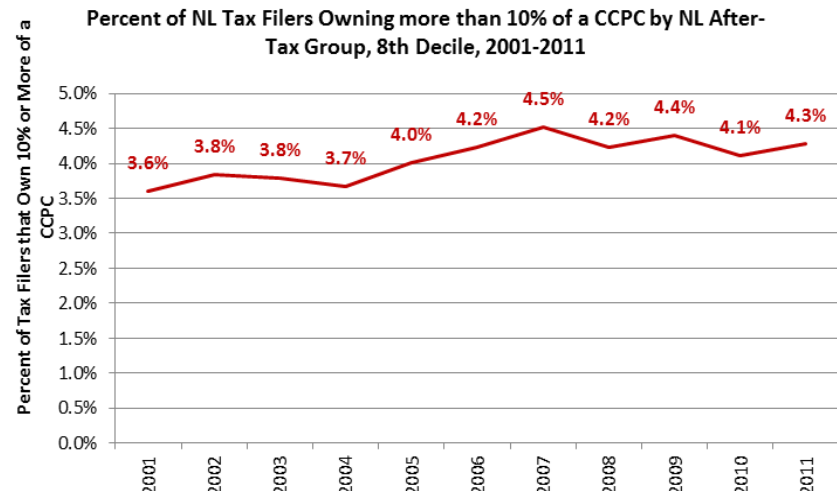
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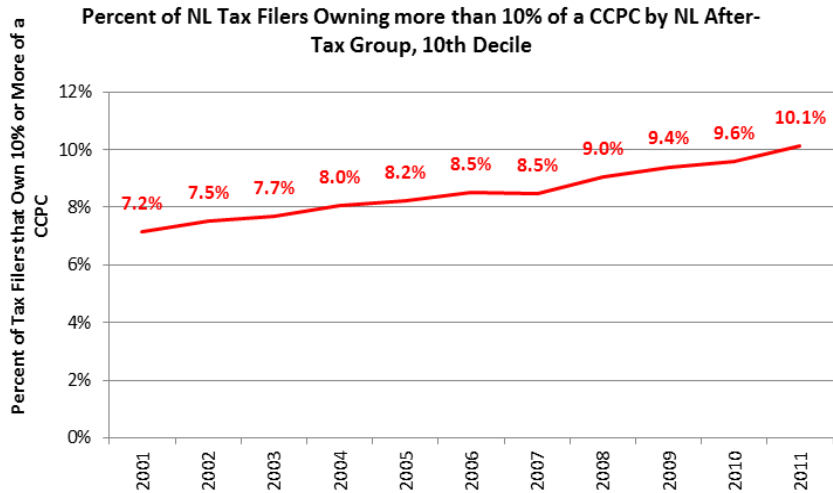


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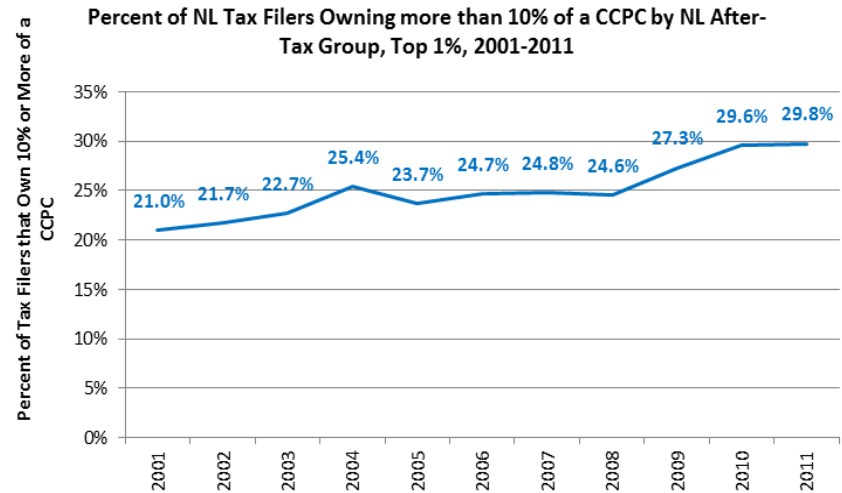


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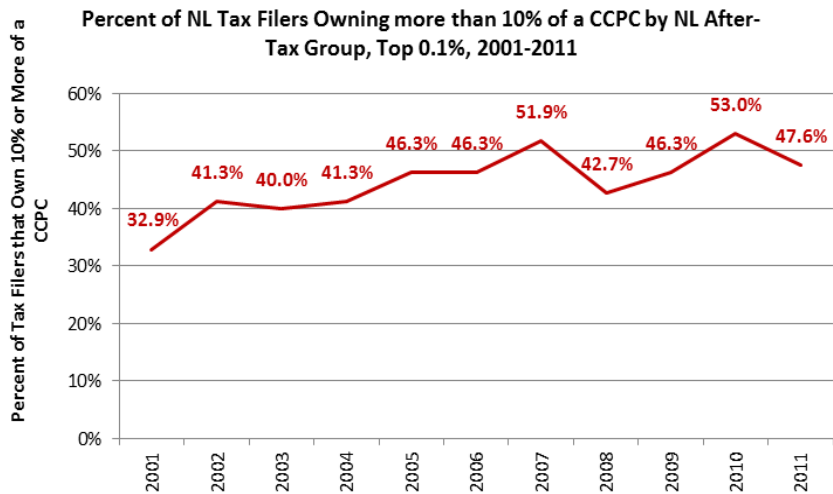
All Income Groups Take Advantage of the CCPC Option, but Higher Income Tax Filers Utilize it More (3)



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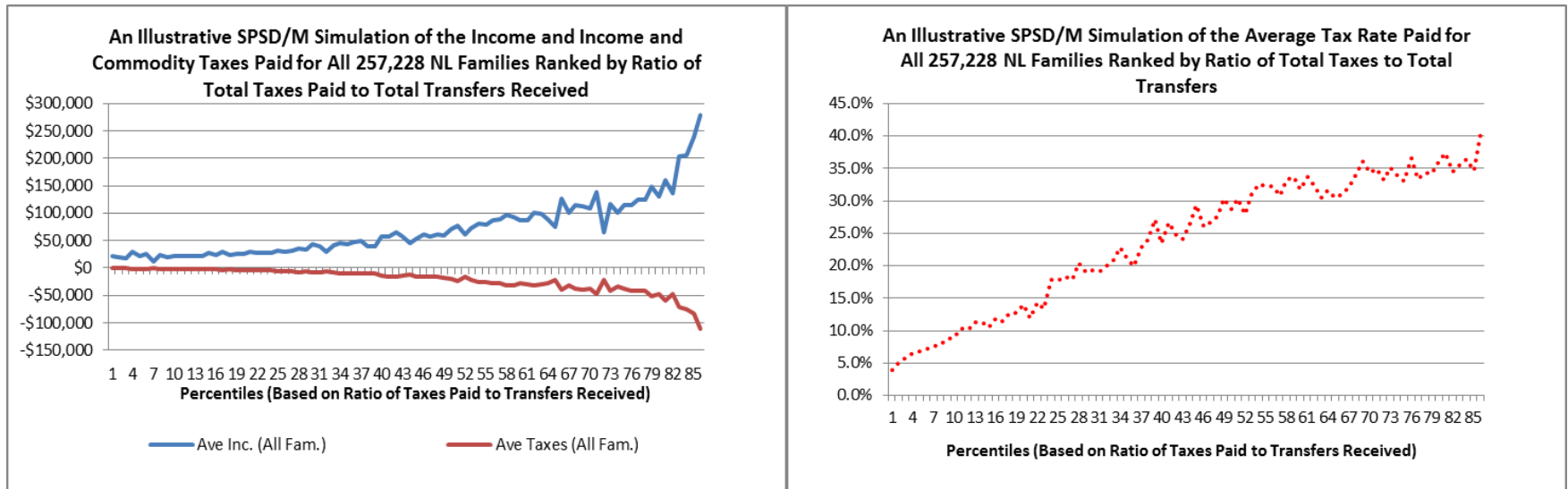
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In NL, the finer you make the top income group, the higher is the usage of the CCPC option, but this appears to be lower than the Canadian figures reported by Wolfson et al.

Total Income, Taxes and Progressivity (2016 Data)

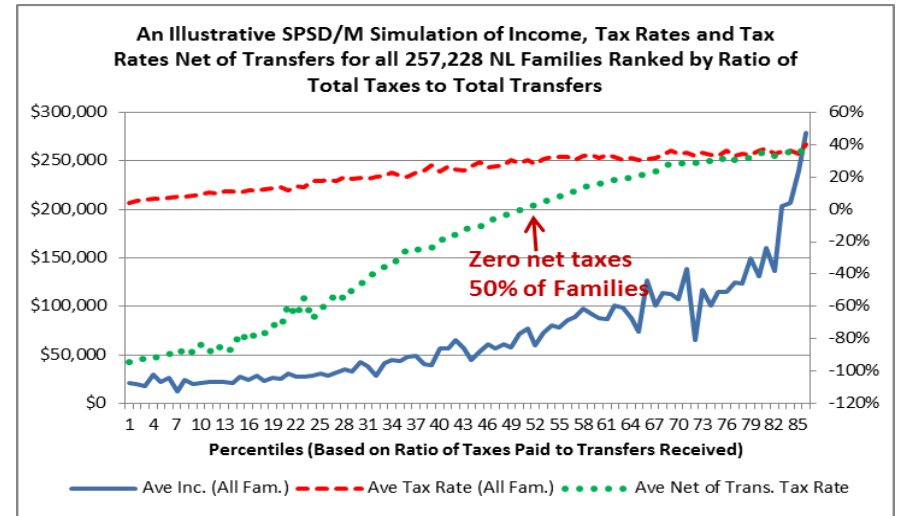
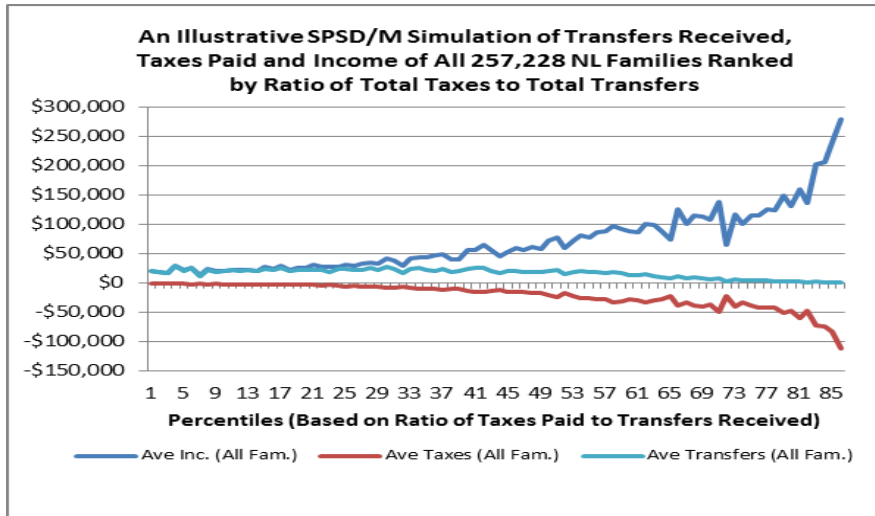


Fairness, as reflected in vertical equity, is tied to progressivity of the tax system

- Those with a greater ability to pay do pay relatively more in taxes, but how much more is a value judgement.

Horizontal equity pertains to equals being treated equally.

Total Income, Taxes, Transfers & Progressivity (2016 Data)



	Share of families	Share of transfers	Share of taxes	Average transfers	Average taxes
Net beneficiaries (index < 1.0)	50.4%	76.3%	14.2%	\$21,710	\$6,982
Net contributors (index > 1.0)	49.6%	23.7%	85.8%	\$6,870	\$42,913
Total	100.0%	100.0%	100.0%	\$14,354	\$24,792

Only half of household are net contributors.

Taxes are significantly more progressive in NL, when transfers are considered.

This may have implications for vertical and horizontal equity.

It may implication for whether changes to the CCPC are warranted.

It is important to think of changes to taxes in holistic framework, rather than piecemeal.

Conclusion

- The use of CCPCs in NL follows a similar pattern to Canada, but is relatively lower.
- NL is similar to Canada in that the use of CCPCs increases with income. It is most heavily utilized by the one-tenth of one percent income group, which is small in NL (e.g., 200 tax filers).
- The NL tax system is already progressive and whether it should be more so, as would be implied by the changes to the CCPCs, is matter of opinion or a value judgement.
- The availability of transfers accentuates the degree of progressivity of NL tax system and the presence of transfers can have implications for horizontal equity.
- While the middle class have not been “hollowed out” in Canada and only slightly in NL and our simulation for 2016 suggests a growth in the middle class in both jurisdictions.
- The problem with income sprinkling is that the individual is the tax paying unit. Income sprinkling could be dealt with by having the family as the tax paying unit as we appear to do for other policy issues (e.g., the equivalized family concept is used in developing a poverty reduction strategy for Canada)
- Passive investment and capital gains exemptions seem to violate horizontal equity and need to be dealt with in some form or another
- It might be time to reconsider a somewhat broad examination of our personal tax system, since it has been over 50 years since the appointment of the Carter Commission.