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Incomes of the Affluent: The Role of Canadian Controlled Private Corporations

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Statistics Canada

St. John's, Newfoundland

October 16, 2015

Preface

- This study is very much a work in progress
- The data on which it is based have never before been used at this level of detail
- The data, coming as they do from various aspects of the administration of Canada's income tax system, were not designed for the kind of analysis presented. They are therefore incomplete in a number of respects
- Still, the data are of sufficient quality, and the questions being addressed of sufficient importance, that valuable insights have been obtained

Background/Motivation

- Recent interest in data on rising income inequality
- Most analysis focusing on personal income
 - SLID and more recently T1 income tax returns
- But per the Income Tax Act, income can stay as retained earnings in private companies (CCPCs - Canadian Controlled Private Corporations)
- This talk: Summary of results to date from SSHRC funded research linking individual tax files with CCPCs
 - Wolfson, Veall, Brooks, Murphy

Background/Motivation

- Statistics Canada
 - Innovative use of administrative data
 - Impact of income retained in CCPCs on the distribution of individual incomes
 - Little is known about the characteristics of owners of Canadian controlled private corporations
 - CCPC ownership vs. Self-employment
 - Provide initial characterization of CCPC owners
 - Support innovative academic research

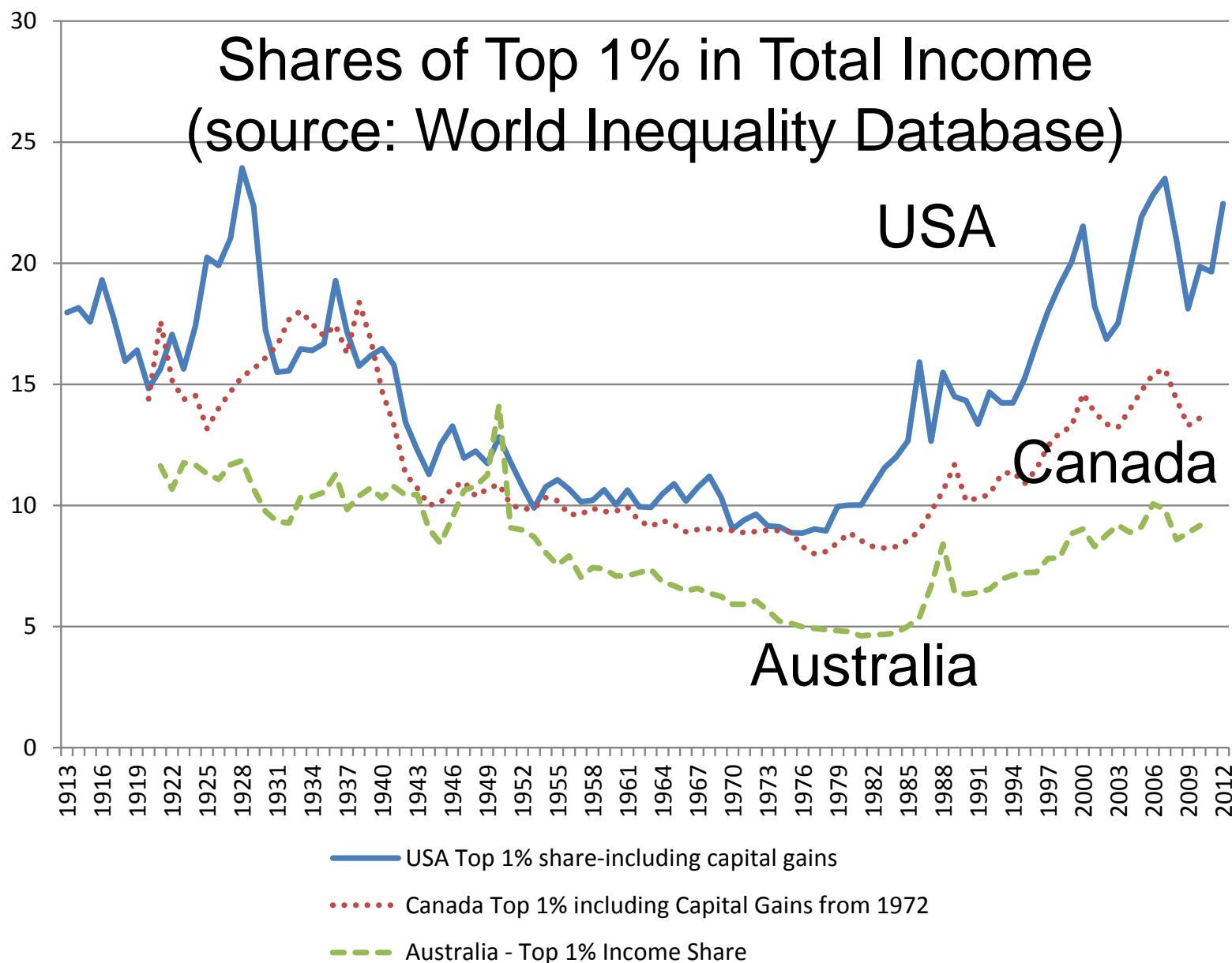


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Shares of Top 1% in Total Income (source: World Inequality Database)





Standard Individual-Level Income Data May Be Inaccurate

- Level of income inequality (e.g. income shares of top quantiles) may be understated
 - unknown amount of income retained in CCPCs
 - income splitting with close family members
- Income inequality trends may be overstated or understated
 - e.g. if amount of income retained in CCPCs or distributed to family members has been changing significantly over time



Standard Individual-Level Income Data May Be Inaccurate

- International comparisons
 - e.g. in U.S. incentives to incorporate small businesses are very different, so omission of closely held corporate income could bias results differentially
- Assessments of income volatility
 - e.g. if CCPC incomes “buffer” year to year variations observed in individual T1 incomes

This Presentation

- Data and linkage methodology
- Findings
 - Characteristics of CCPC owners
 - Impact on the distribution of income
 - Prevalence of Income splitting
 - Use of CCPC's by professionals
- Concluding remarks



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LINKAGE METHODOLOGY

Context

Major Challenges

- Need to link tax return data from several sources
- Linkage keys not always present
- Data are generally not “analysis ready”

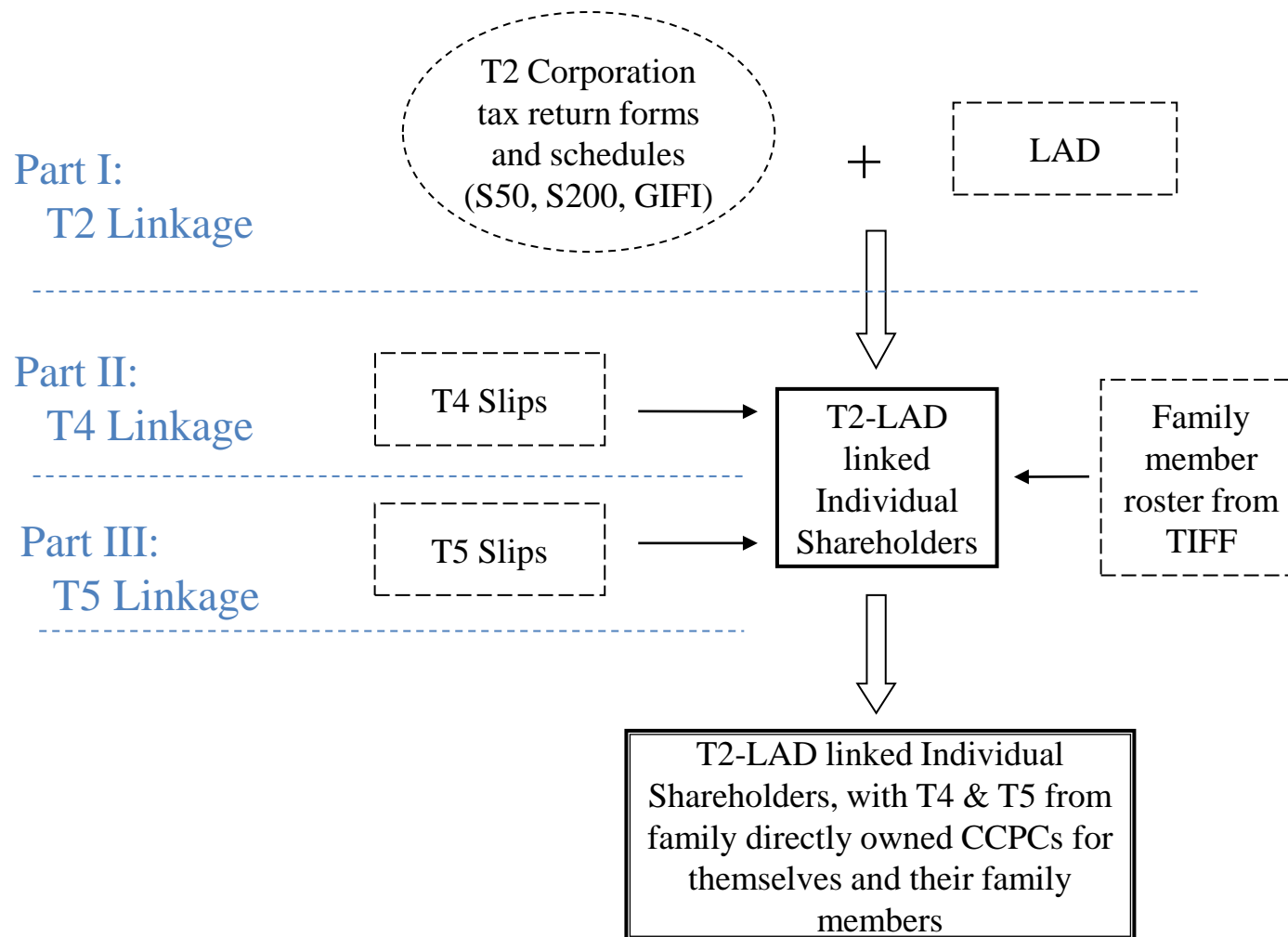
Further Challenges

- Fiscal year versus calendar year
- Common share vs. Preferred share
- Shifting industry codes
- No occupational codes

Data Sources

- **Individual tax returns**
 - **LAD** (Longitudinal Administrative Data, 20% T1FF)
T1FF (T1 Family File)
- **Corporation tax returns**
 - Key for linkage: owners ID
 - Identify CCPCs
 - Financial information of CCPCs
 - Income Statements
 - Balance Sheets
 - NAICS (North American Industry Classification System)
 - **T2 schedules:**
 - Schedule 50 (private corp. 10%+)
 - Schedule 200
 - GIF1 (General Index of Financial Information)
Schedule 125
Schedule 100
 - CRA's BN database
- **Wages** paid by CCPC to owners and their family members
 - **T4 slips**
- **Dividends** paid by CCPC to owners and their family members
 - **T5 slips**
- ~~■ Money paid to family member through **Trust funds** by CCPC owners → **T3 slips** (No ID for linkage)~~

Overview of the Linkage Framework





Linkage Part 1: T2-LAD

■ Key of the linkage – Schedule 50



SHAREHOLDER INFORMATION (2006 and later taxation years)

SCHEDULE 50
Code 0601

Name of corporation ABC INC.	Business Number BN_ABC	Taxation year-end Year: Month: Day:
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All private corporations must complete this schedule for any shareholder who holds 10% or more of the corporation's common and/or preferred shares.

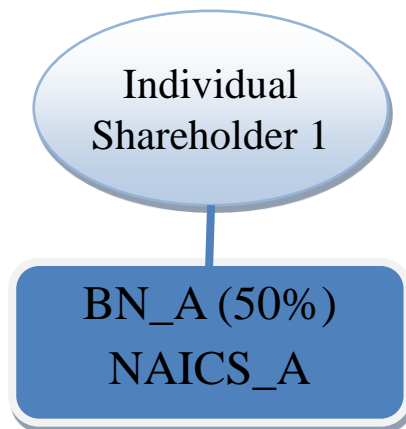
Provide only one number per shareholder					
Name of shareholder (after name, indicate in brackets if the shareholder is a corporation, partnership, individual, or trust)	Business Number (If a corporation is not registered, enter "NR")	Social insurance number	Trust number	Percentage common shares	Percentage preferred shares
100	200	300	350	400	500
1. Individual A		SIN_A		50	30
2. Corporation B	BN_B			30	65
3. Trust C			T_C	20	
4.					



Linkage Part 1: T2-LAD

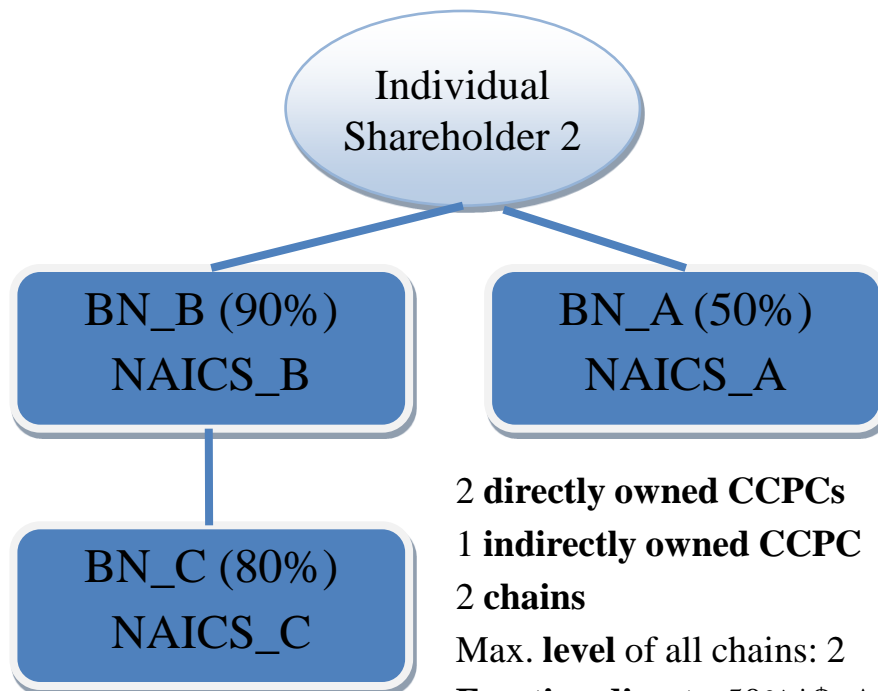
■ Ownership Structure for individual owners

Example 1:



1 directly owned CCPC
1 chain
1 level
Fraction= $50\% * \$_A$
NAICS: NAICS_A

Example 2:

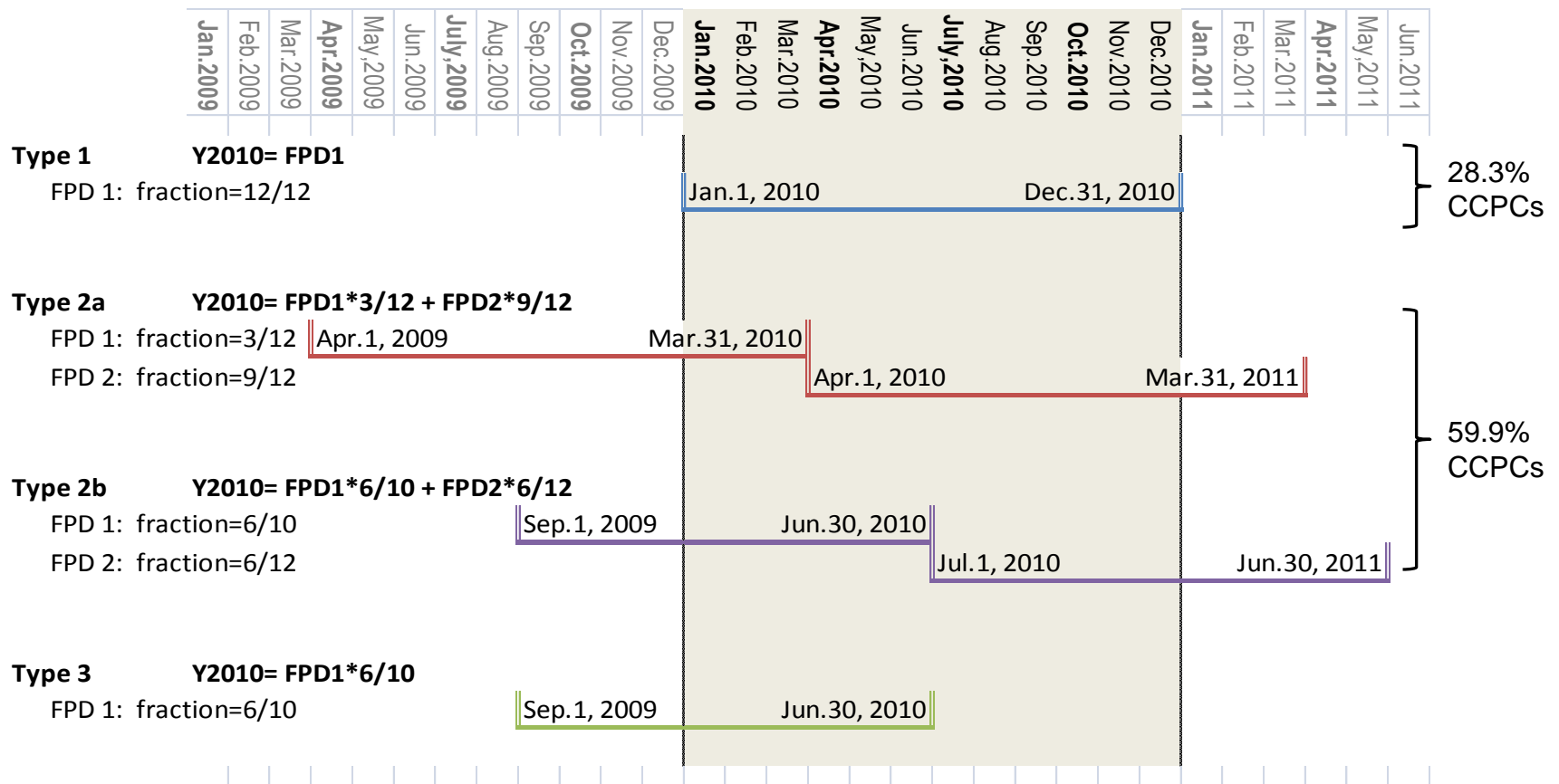


2 directly owned CCPCs
1 indirectly owned CCPC
2 chains
Max. level of all chains: 2
Fraction direct= $50\% * \$_A + 90\% * \$_B$
Fraction indirect= $90\% * 80\% * \$_C$
NAICS: NAICS_B
(if $90\% * RE_B > 50\% * RE_A$)



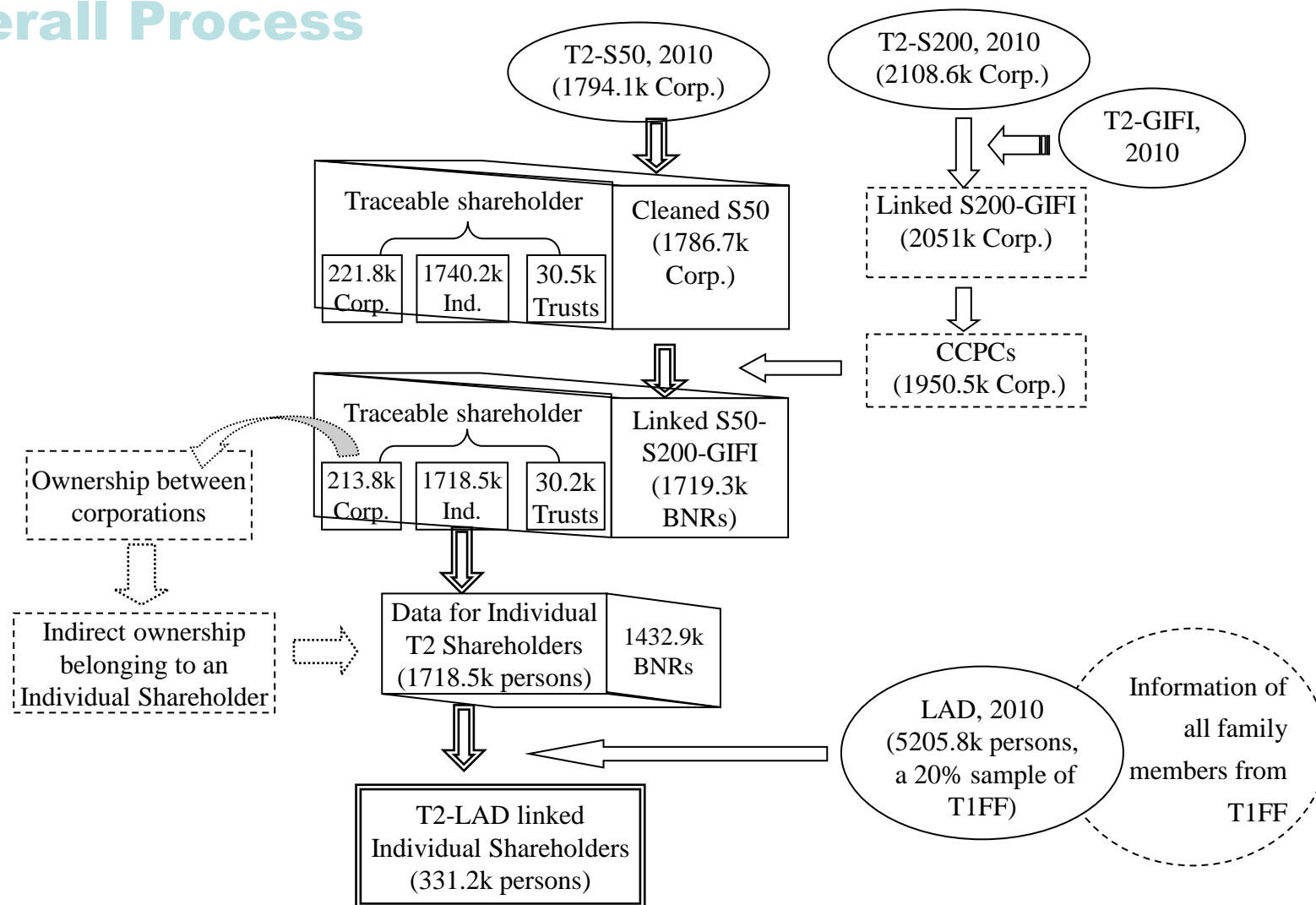
Linkage Part 1: T2-LAD, Calendarization

T2 Fiscal Period and Calendarization - examples



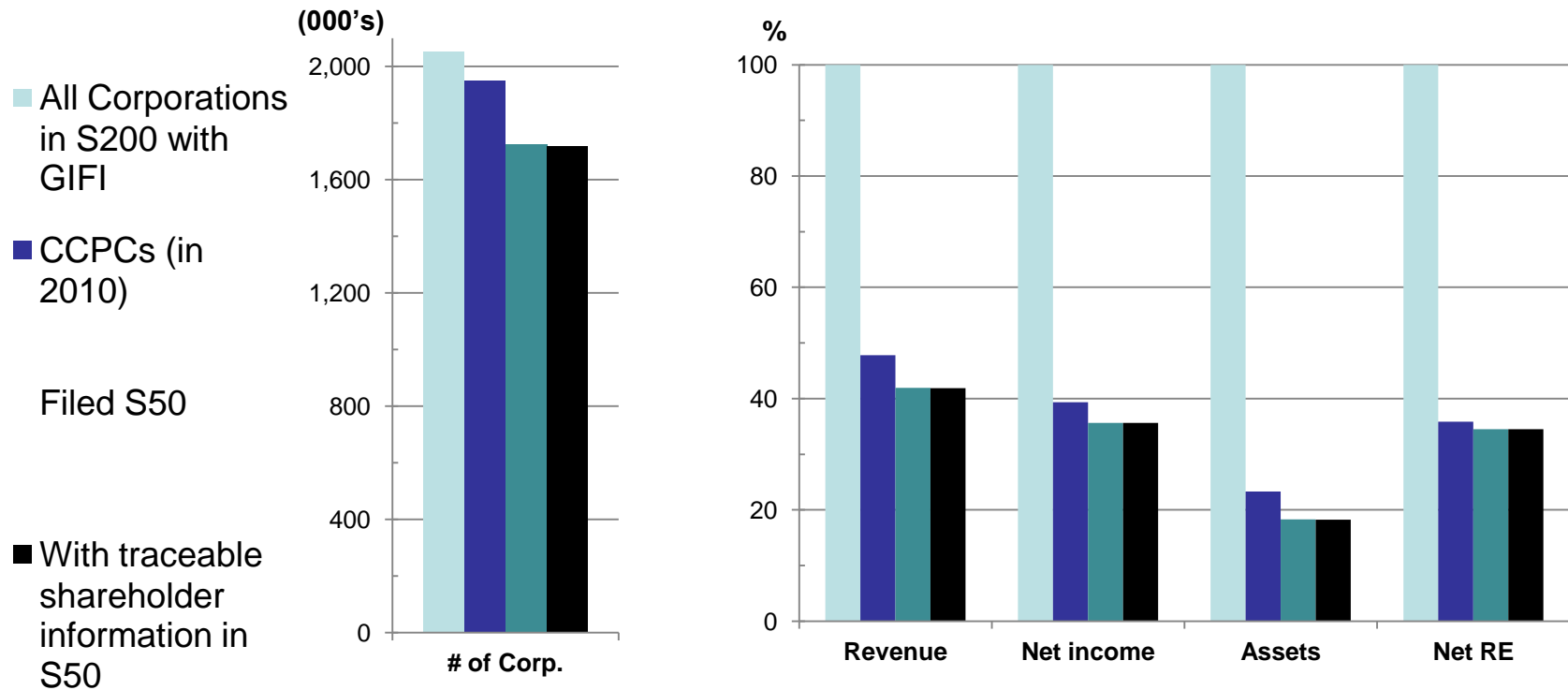
Linkage Part 1: T2-LAD

Overall Process



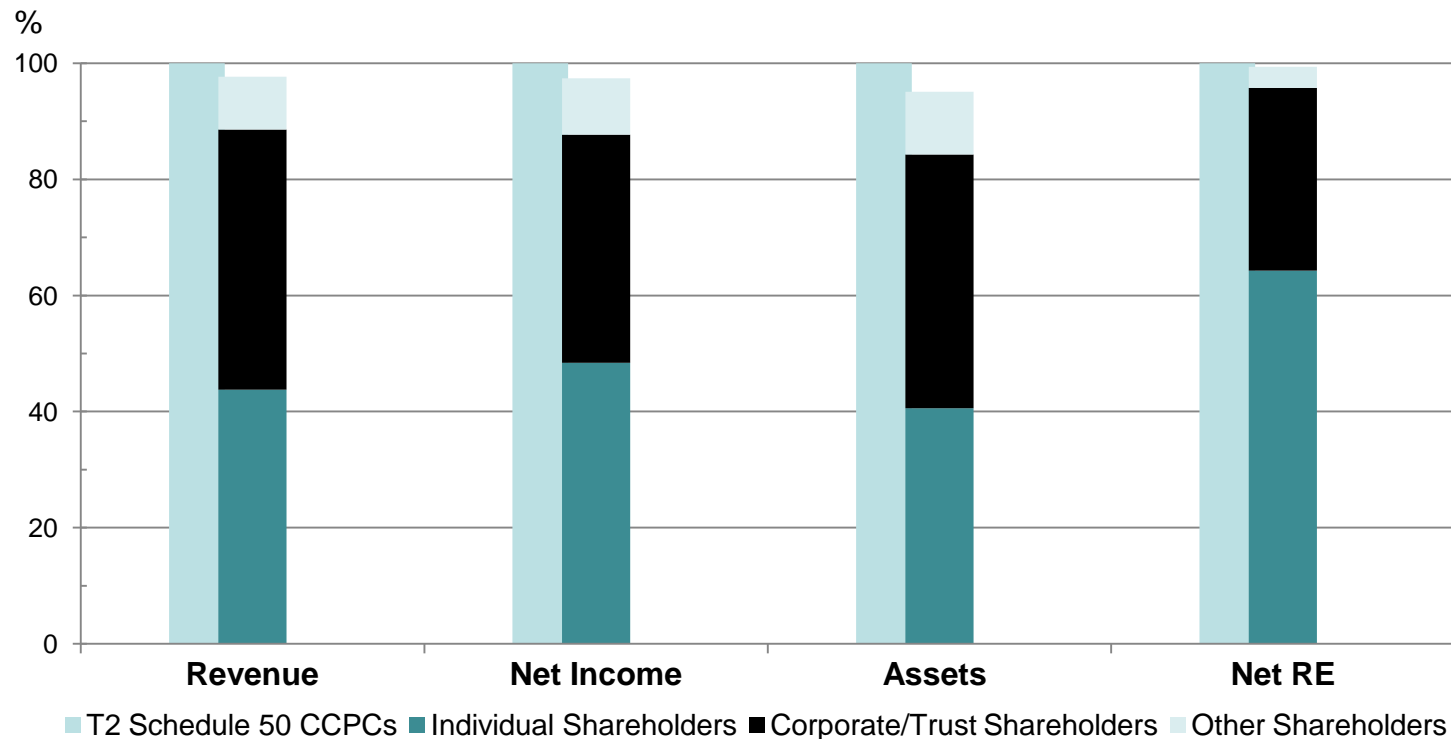
Linkage Part 1: T2-LAD

Corporations by data cleaning and linkage process, 2010



Linkage Part 1: T2-LAD

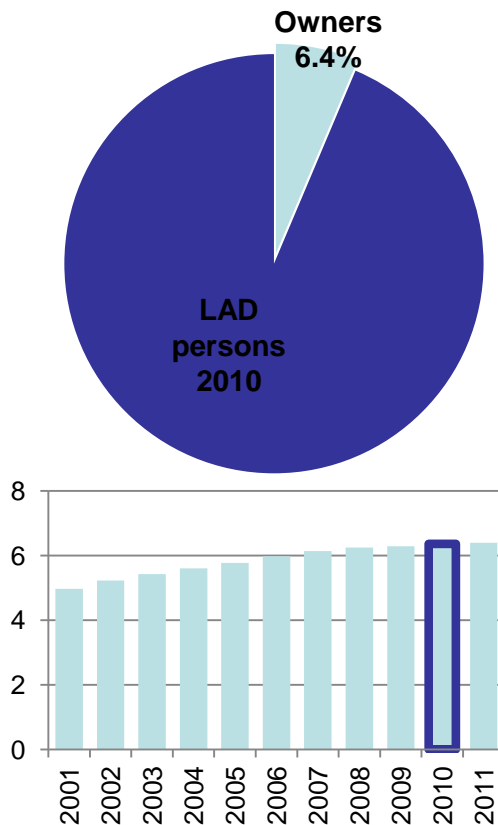
Fractions of the major financial items allocated to owners, Linked S200-GIFI-S50 CCPCs in 2010



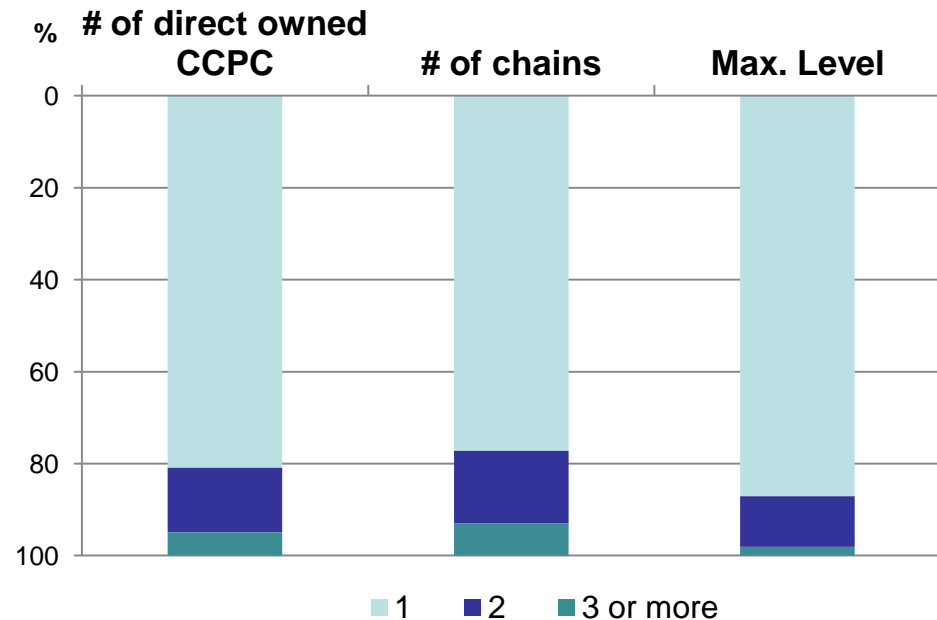
Linkage Part 1: T2-LAD

Brief view of CCPC ownership, T2-LAD linked

% of CCPC owners in LAD



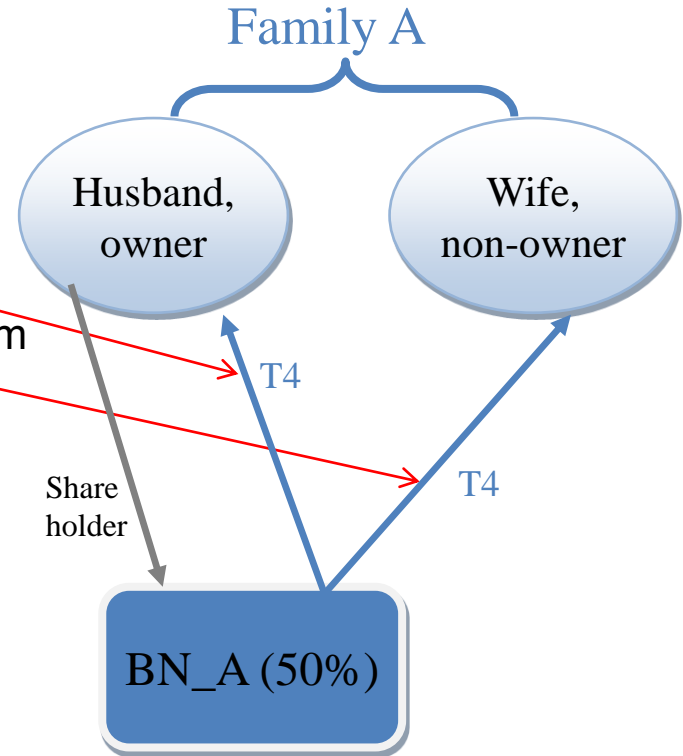
LAD owners by ownership structures, 2010



Linkage Part 2: T4 + T2-LAD

Information added from T4

- Individual level:
 - T4 employment income
 - For owners: T4 received from any directly owned CCPC
 - For owners' family members: T4 received from any CCPC directly owned by the owners
- Firm level – for each CCPC directly owned by a LAD owner:
 - Total T4 employment income paid
 - Total number of employees



Linkage Part 2: T4 + T2-LAD

T4 linkage Rate

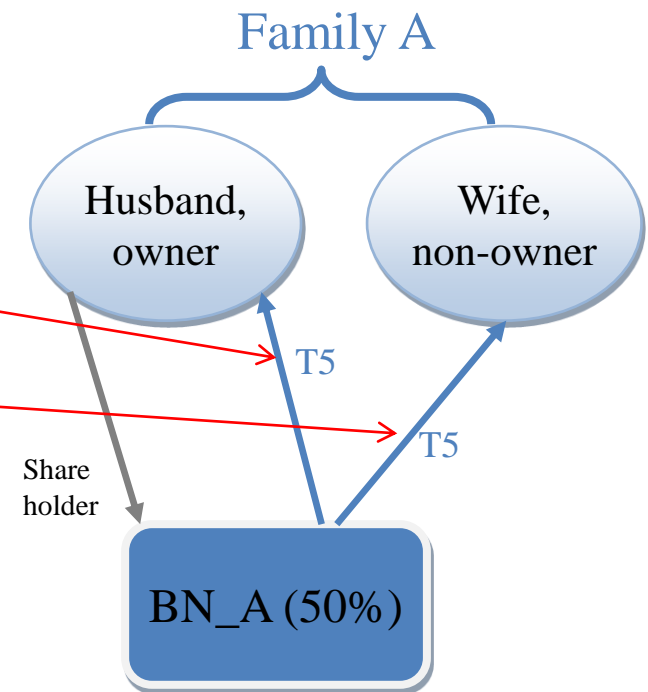
- Among CCPCs owned by a LAD owner,
 - 40.1% issued T4 to their owners and/or their family members
 - 83.9% unlinkable CCPCs did not pay any wage according to GIF

- Among these LAD owners, from the CCPCs directly owned by any of their family members,
 - 43.4% received T4 themselves
 - 15.8% had an owner family member who received T4
 - 10.5% had a non-owner family member who received T4

Linkage Part 3: T5 + T2-LAD

Information added from T5

- T5 contains data on various kinds of investment income
 - Focus is on dividends
- Individual level:
 - For owners: T5 received from any directly owned CCPC
 - For owners' family members: T5 received from any CCPC directly owned by the owner
- Firm level – for each CCPC directly owned by a LAD owner:
 - Total T5 dividends paid



Linkage Part 3: T5 + T2-LAD

Challenges and Limitations - 1

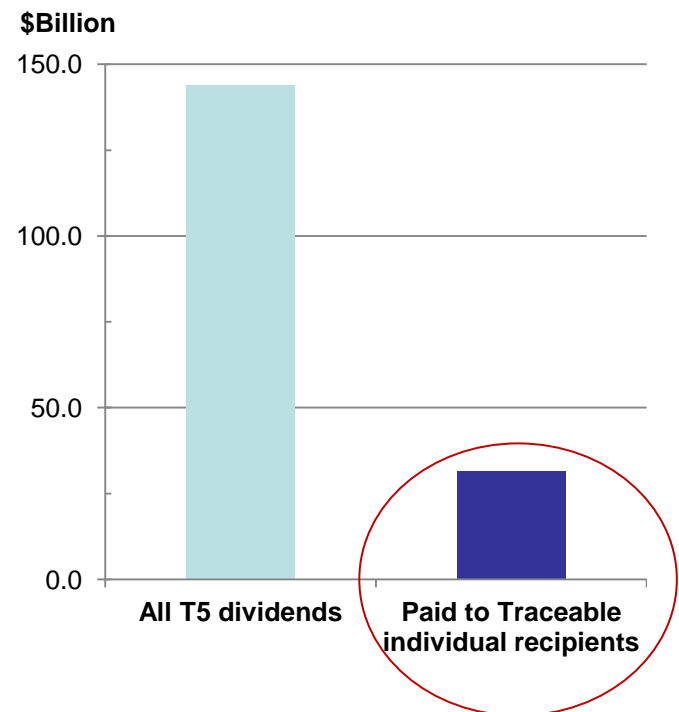
- ID for T5 issuer was different from that for T2 corporations prior to 2009
 - only linkable starting from 2009
- Various types of currency amounts were reported
 - About 95% of all T5 slips were reported in CAD
 - Slips reported in other currencies are excluded

Linkage Part 3: T5 + T2-LAD

Challenges and Limitations - 2

- Various types of recipients on T5
 - Individual;
Corporation;
Association, trust, club or partnership;
Government institution;
 - Only keep individual recipients
 - Missing SIN

**T5 dividends paid
from all corporations**



Linkage Part 3: T5 + T2-LAD

T5 linkage Rate

- Among CCPCs owned by a LAD owner,
 - 25% paid T5 dividends to their owners and/or their family members
 - 87.6% unlinkable CCPCs did not pay any dividends according to GIF

- Among these individual shareholders, from the CCPCs directly owned by any of their family members,
 - 26.6% received T5 dividends themselves
 - 10.6% had an owner family member who received T5
 - 0.8% had a non-owner family member who received T5

Linkage Summary

- Data linkage accurately reflect source data levels and distribution in general
 - Few impacts from non-filers or partial-filers of the S-50
 - Few impacts of missing or unlinked T4 or T5 slips

- Administrative data are not perfect and need careful treatment in practice



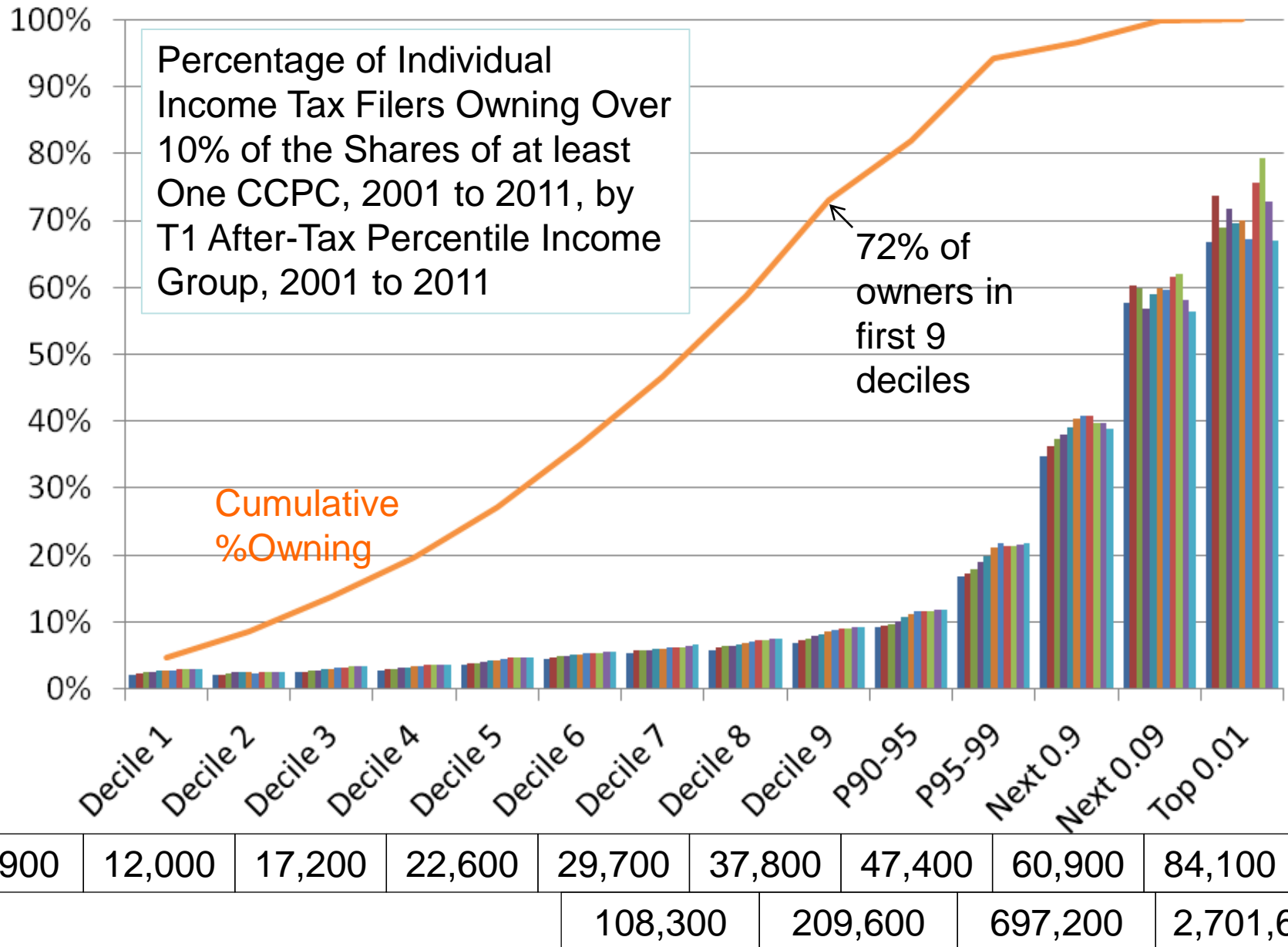
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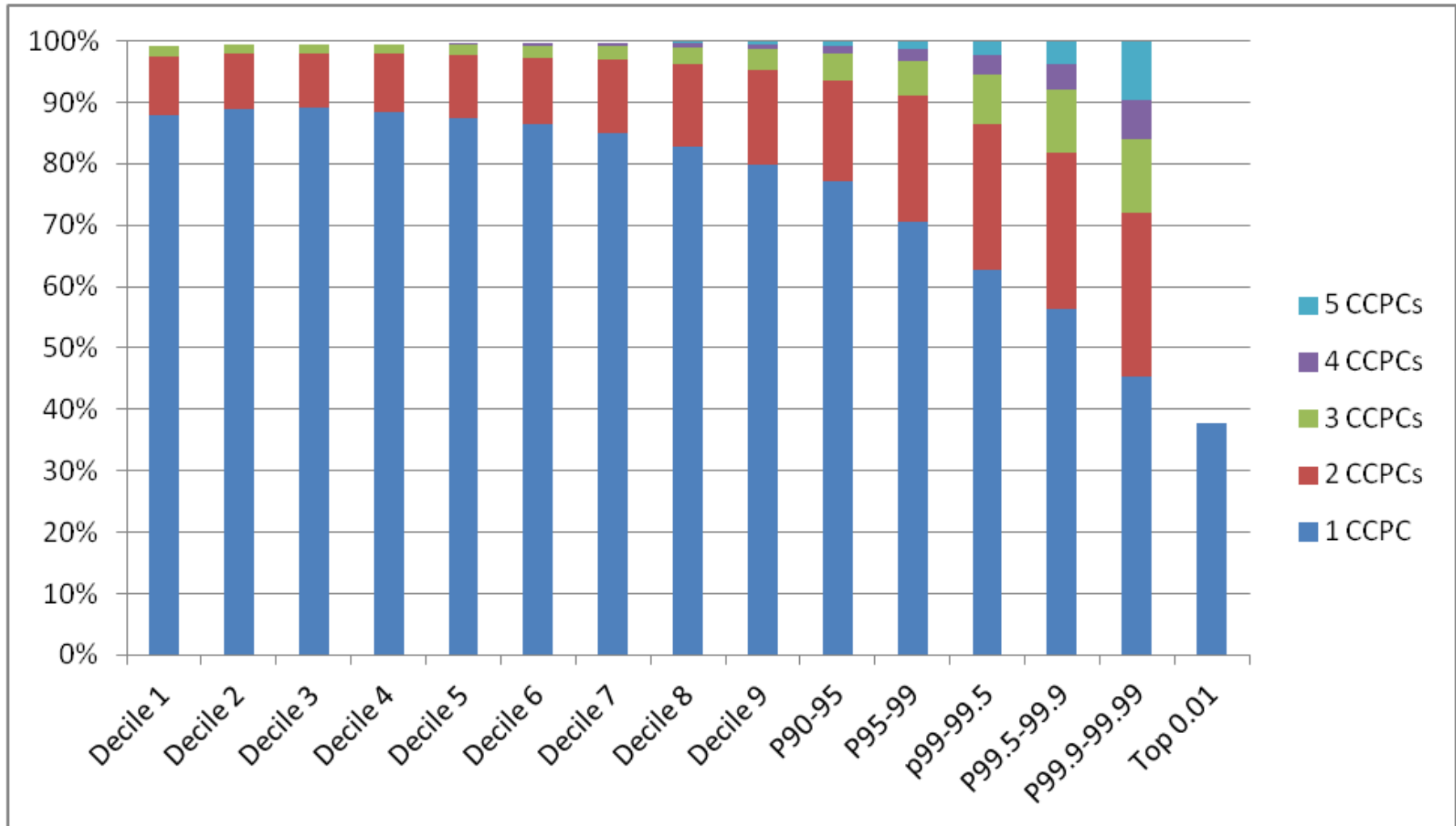
Characteristics of Owners

FINDINGS





Distribution of Owners by Total Income and # of CCPCs owned, 2011

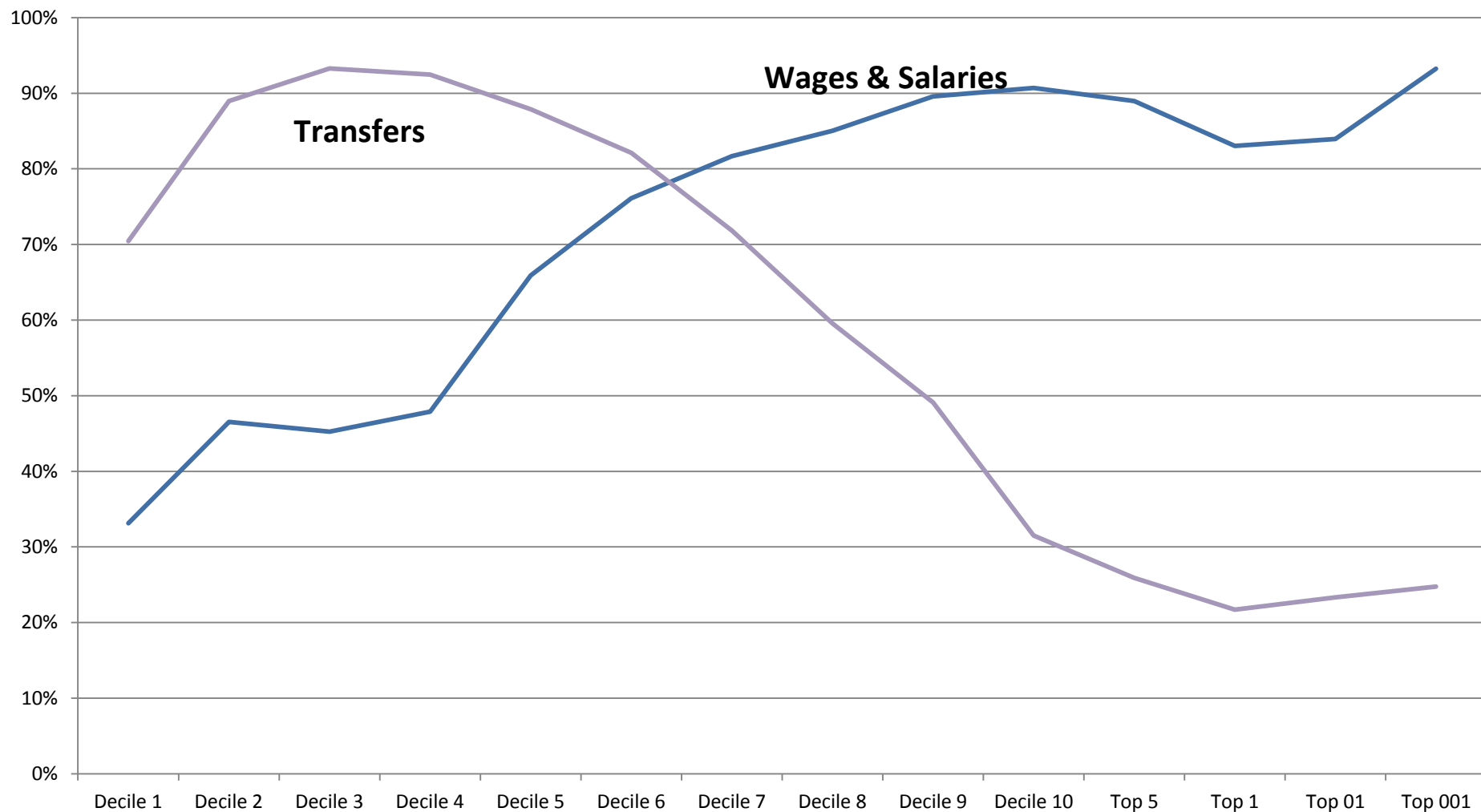


Ownership is spread throughout the income distribution but is more prevalent at the top end

- 6.5% of Filers own > 10% of a CCPC
 - 40% of top 1, 65% of top 0.01 own CCPCs
 - 28% of all owners are in the top decile
- 85% of owners own shares in only 1 CCPC
 - 1.1% of all owners have ownership in 4+ CCPCs
 - 43% of the top 1 own two+ CCPCs, 65% of top 0.01
 - 25% of the top 0.01 have direct ownership in 4+ CCPCs
- Owners' reported shares average 65% ownership of a CCPC

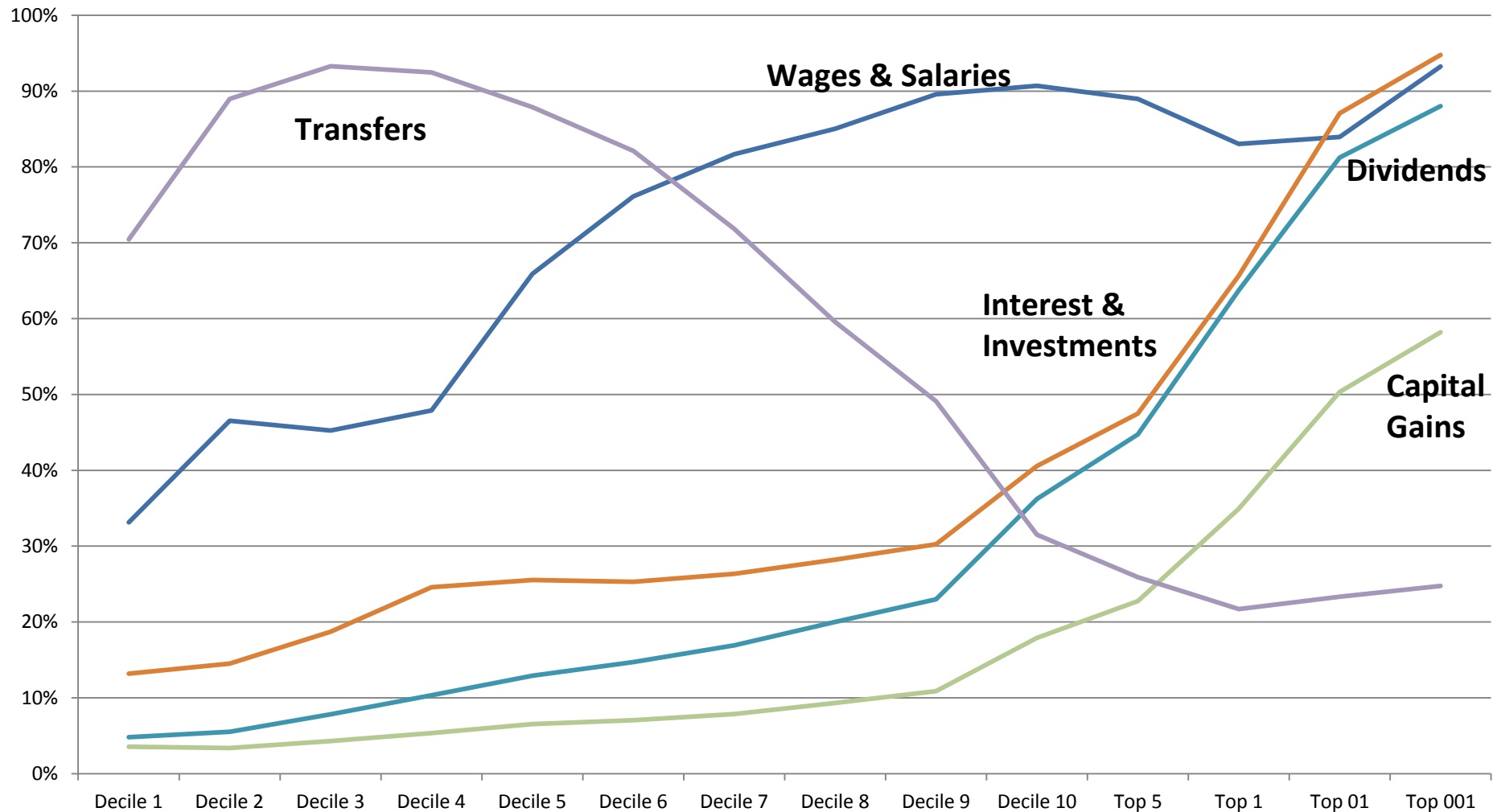


Percentage reporting income by source, LAD 2011



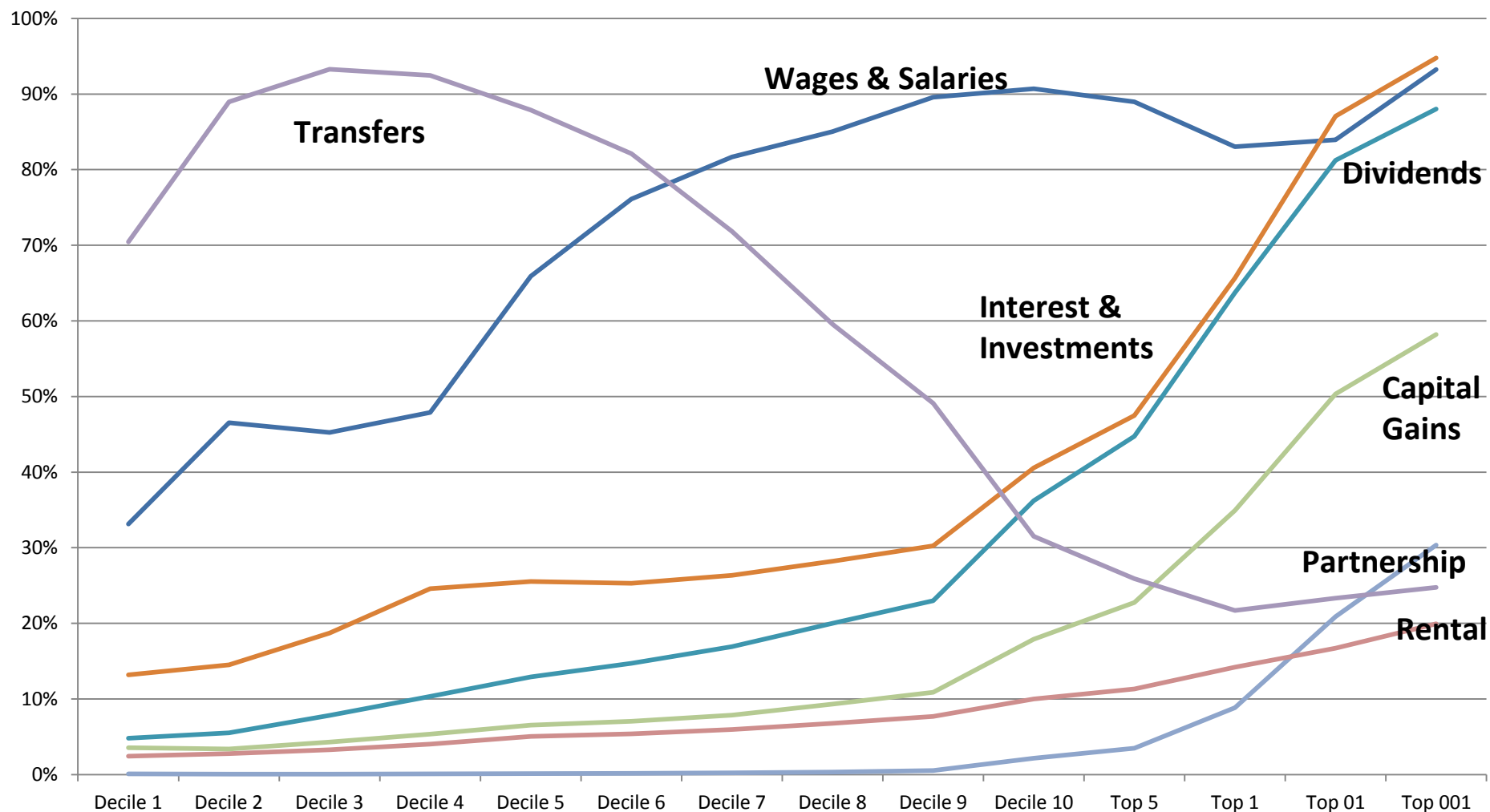


Percentage reporting income by source, LAD 2011



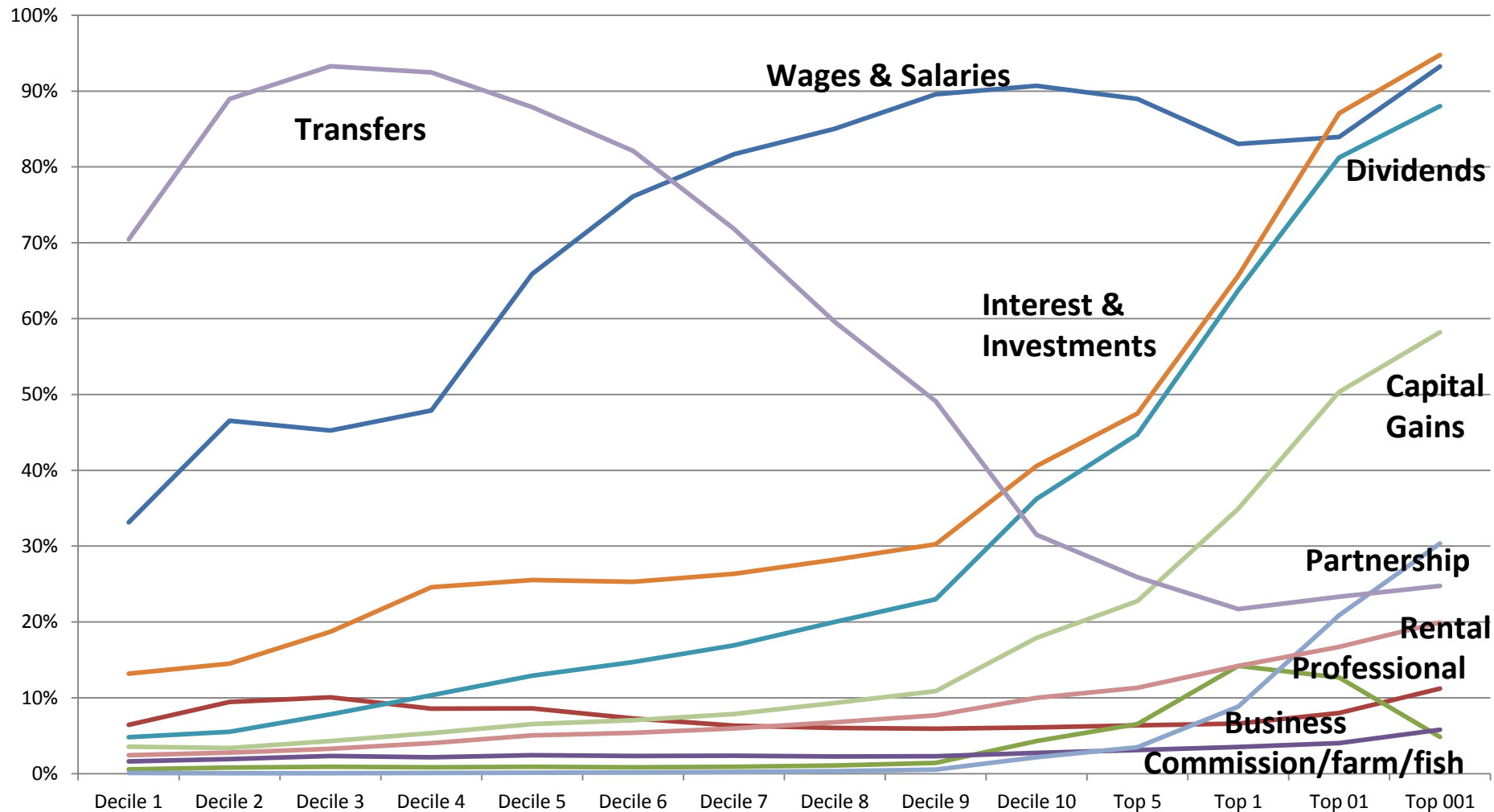


Percentage reporting income by source, LAD 2011



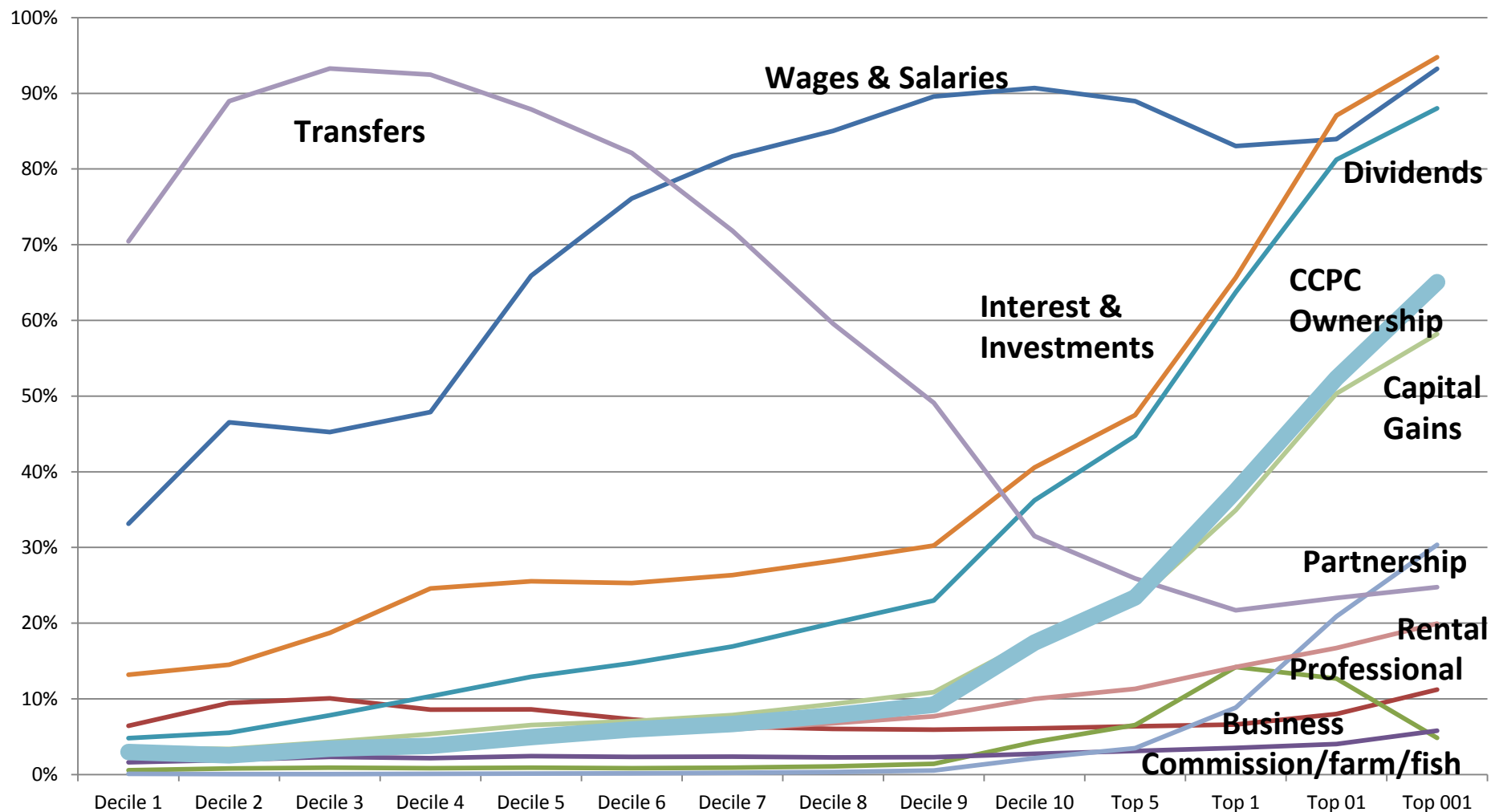


Percentage reporting income by source, LAD 2011





Percentage reporting income by source, LAD 2011

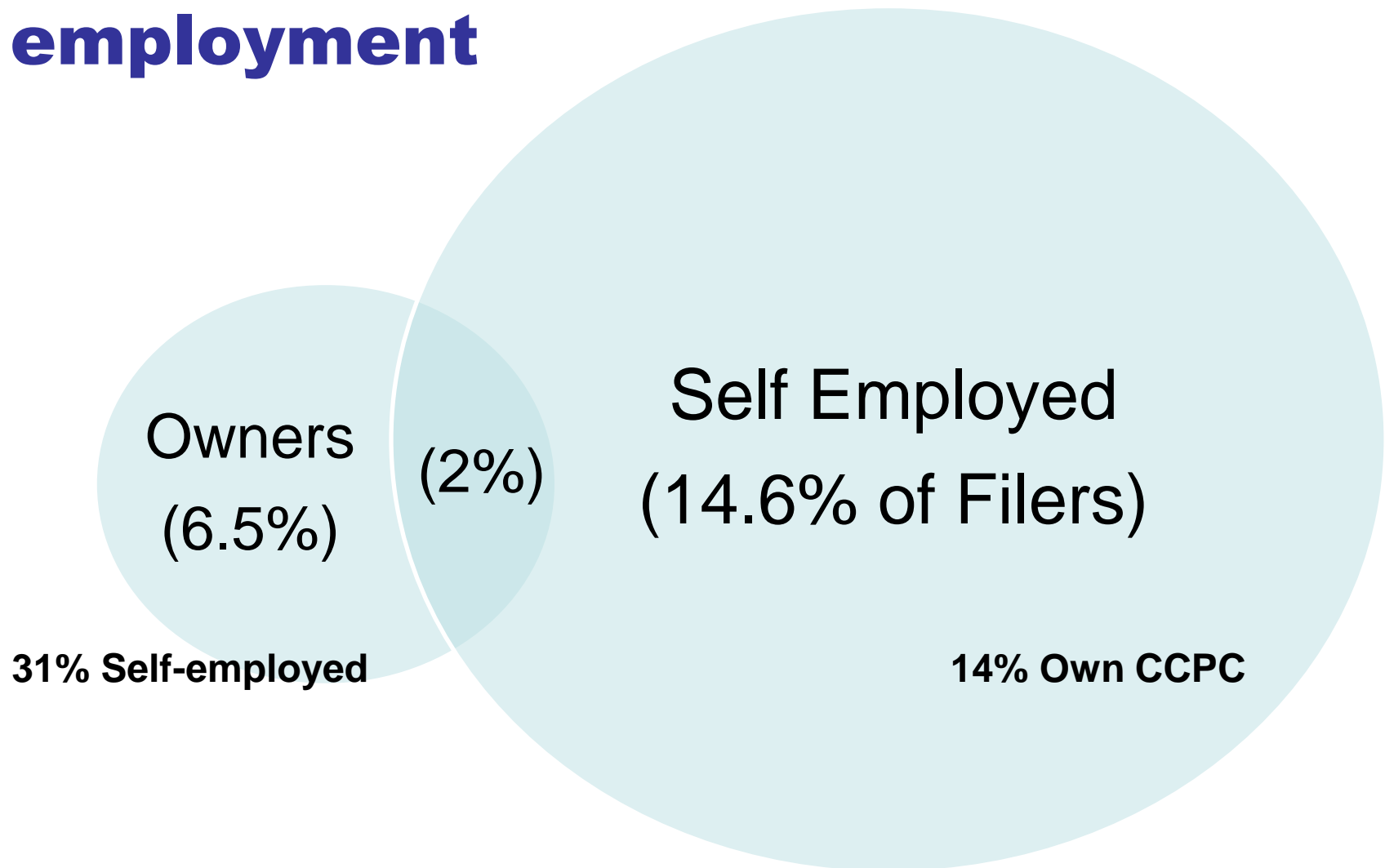


Use of CCPC by top income recipients

- Wealth related income (dividends, interest, capital gains) like CCPC ownership, shows a sharp increase in percentage reporting at higher levels of income
- For the self employed, the proportion of filers in partnerships or having rental income rises sharply at high end while professional and business activity increases to a lesser degree

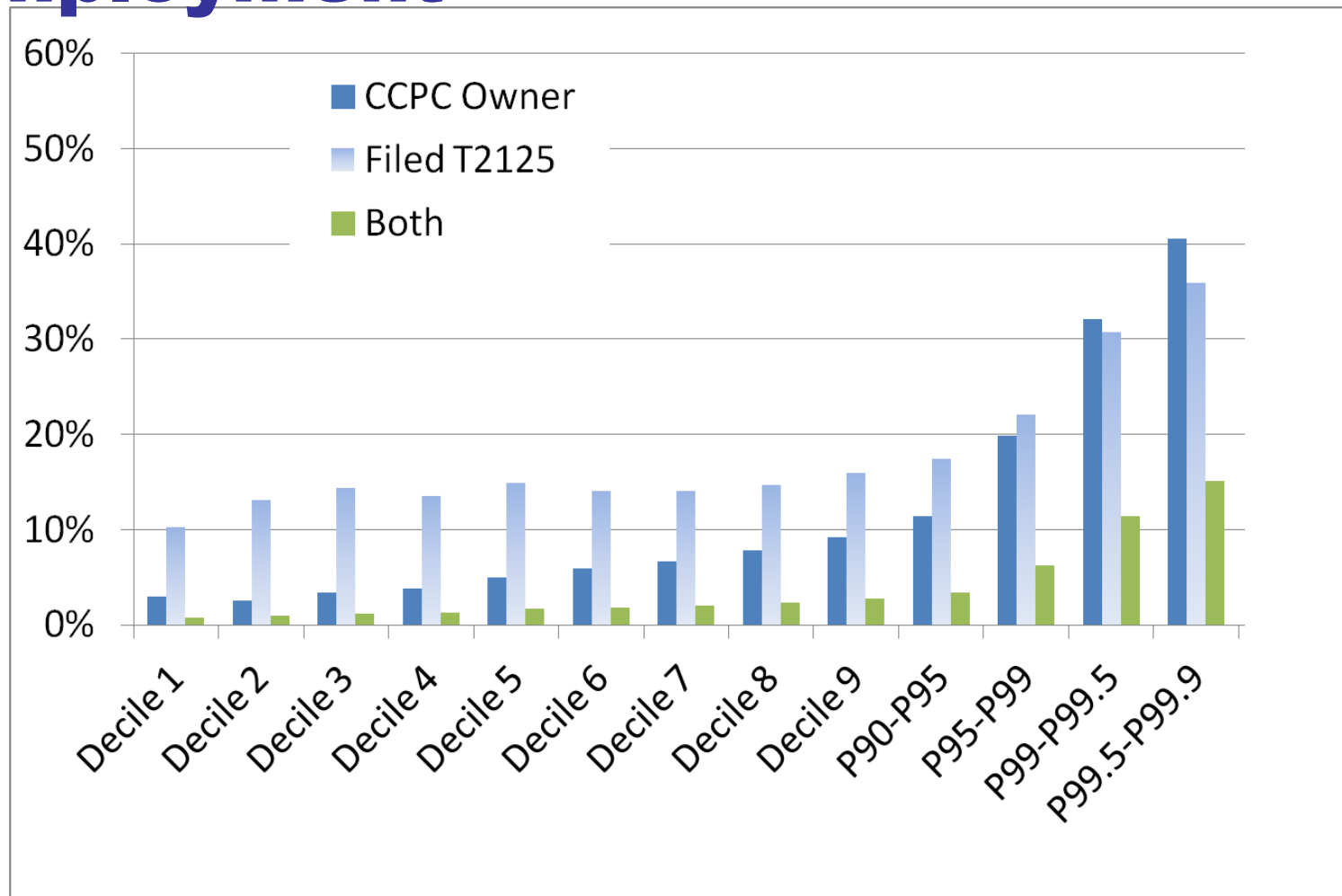


Incidence of Ownership and Self-employment





Incidence of Ownership and Self-employment



Self-employed

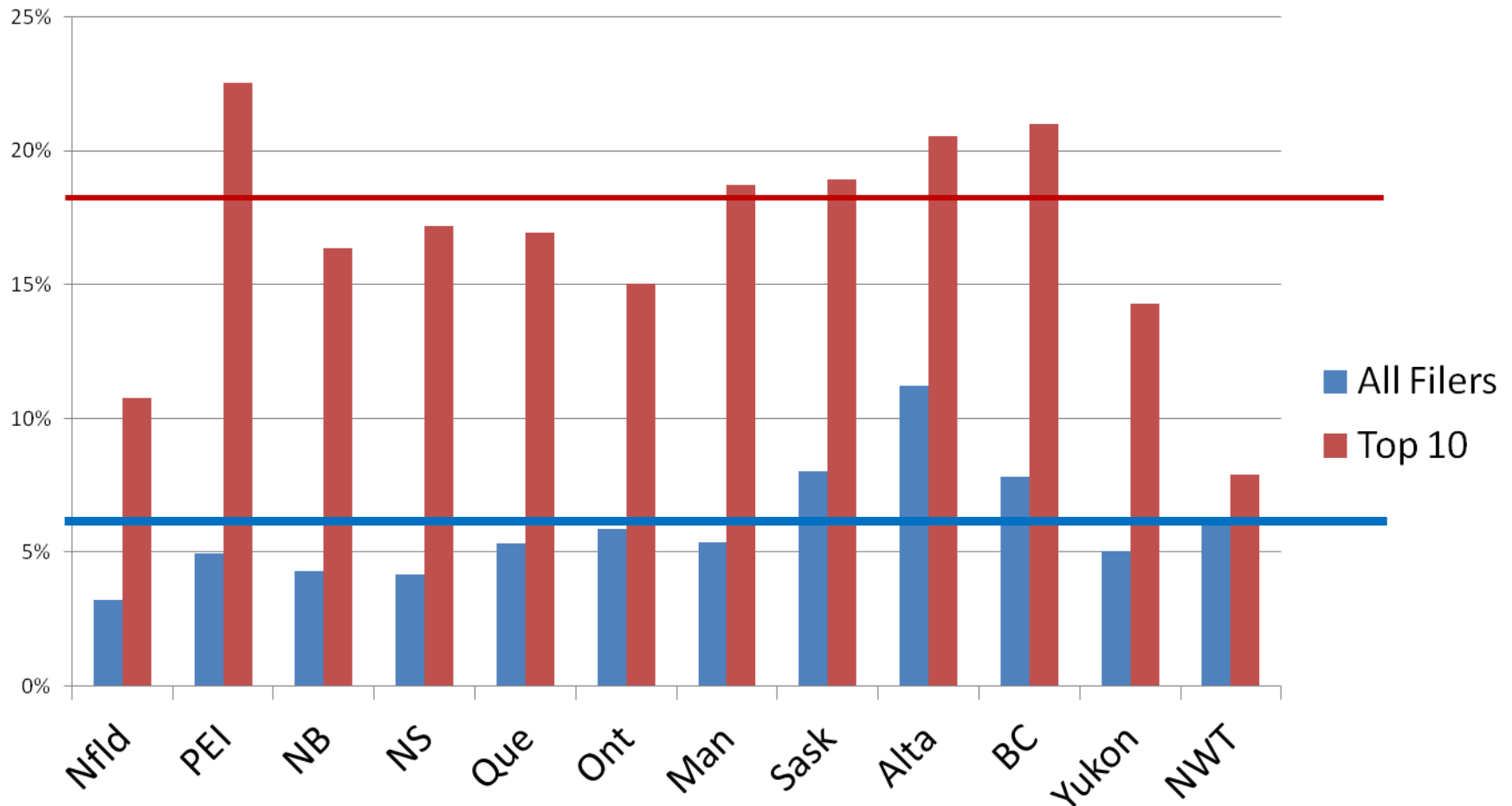
- Self-employment is more prevalent than CCPC ownership at all but the highest incomes
 - 3.8M self-employed vs. 1.7M CCPC owners

- 2% of all filers have both self-employment and CCPC ownership
 - 31% of CCPC owners report self-employment



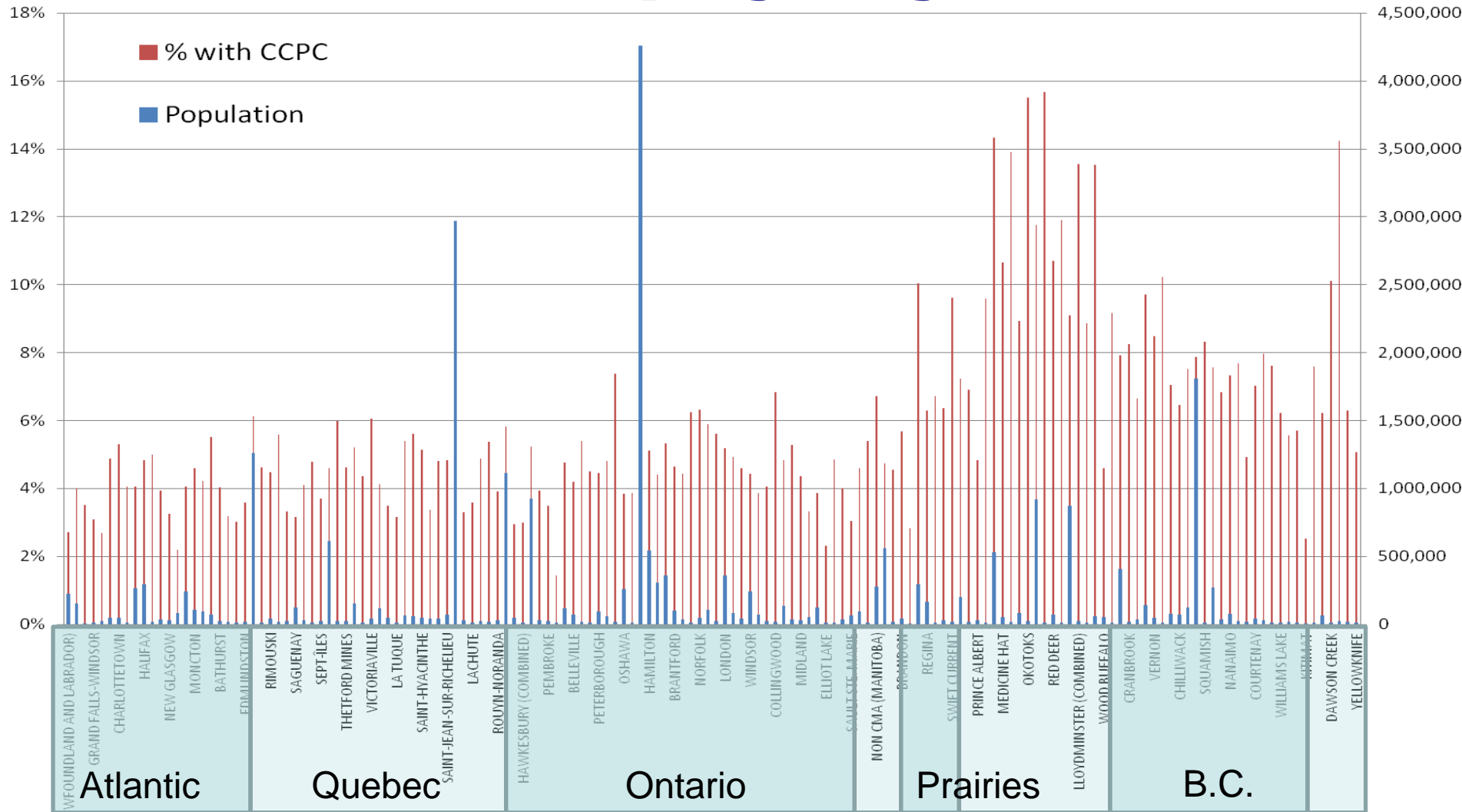
CCPC Ownership by Province

Percentage of Filers Directly owning at least one CCPC, 2010



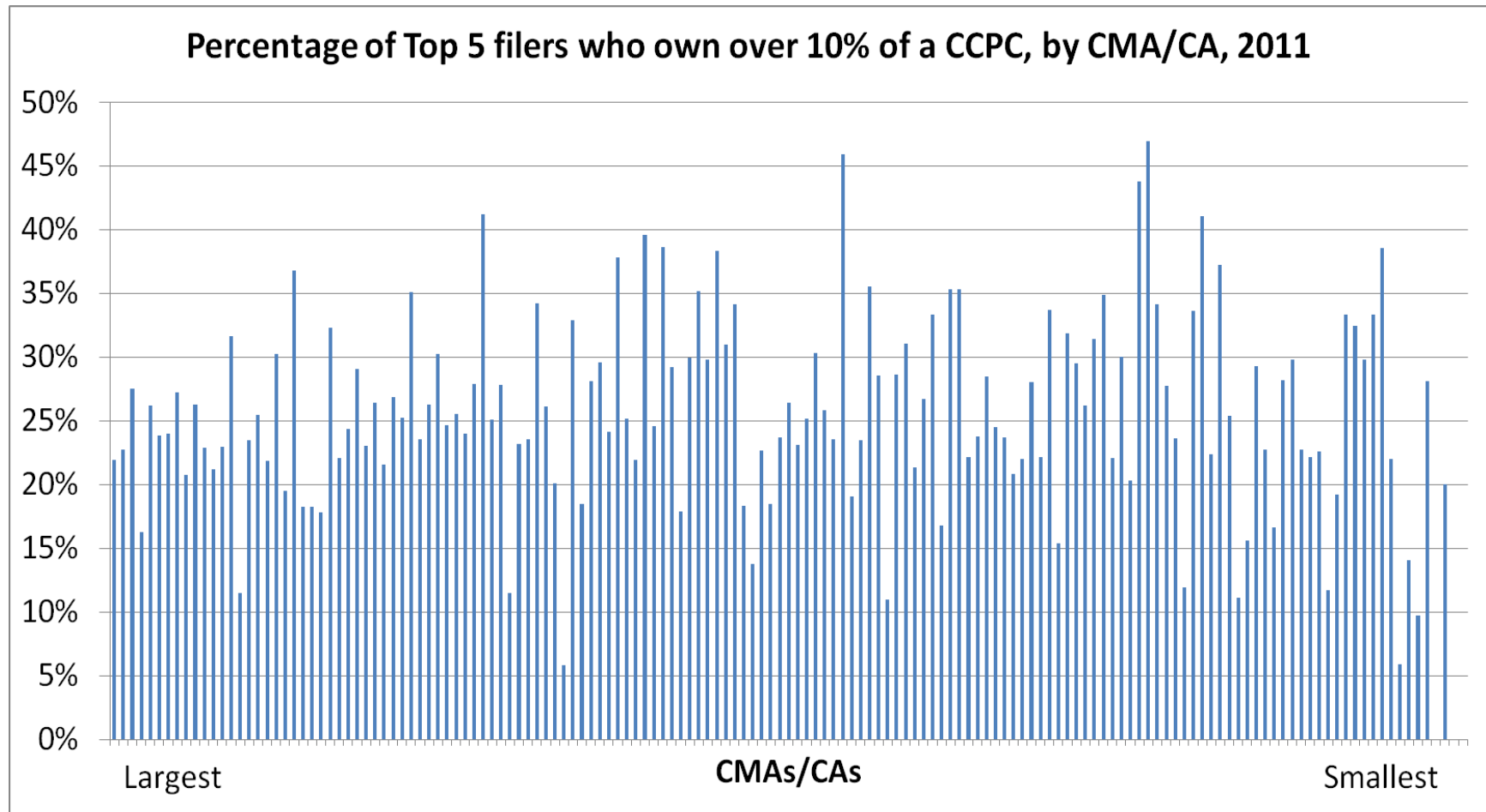


CCPC Ownership by City



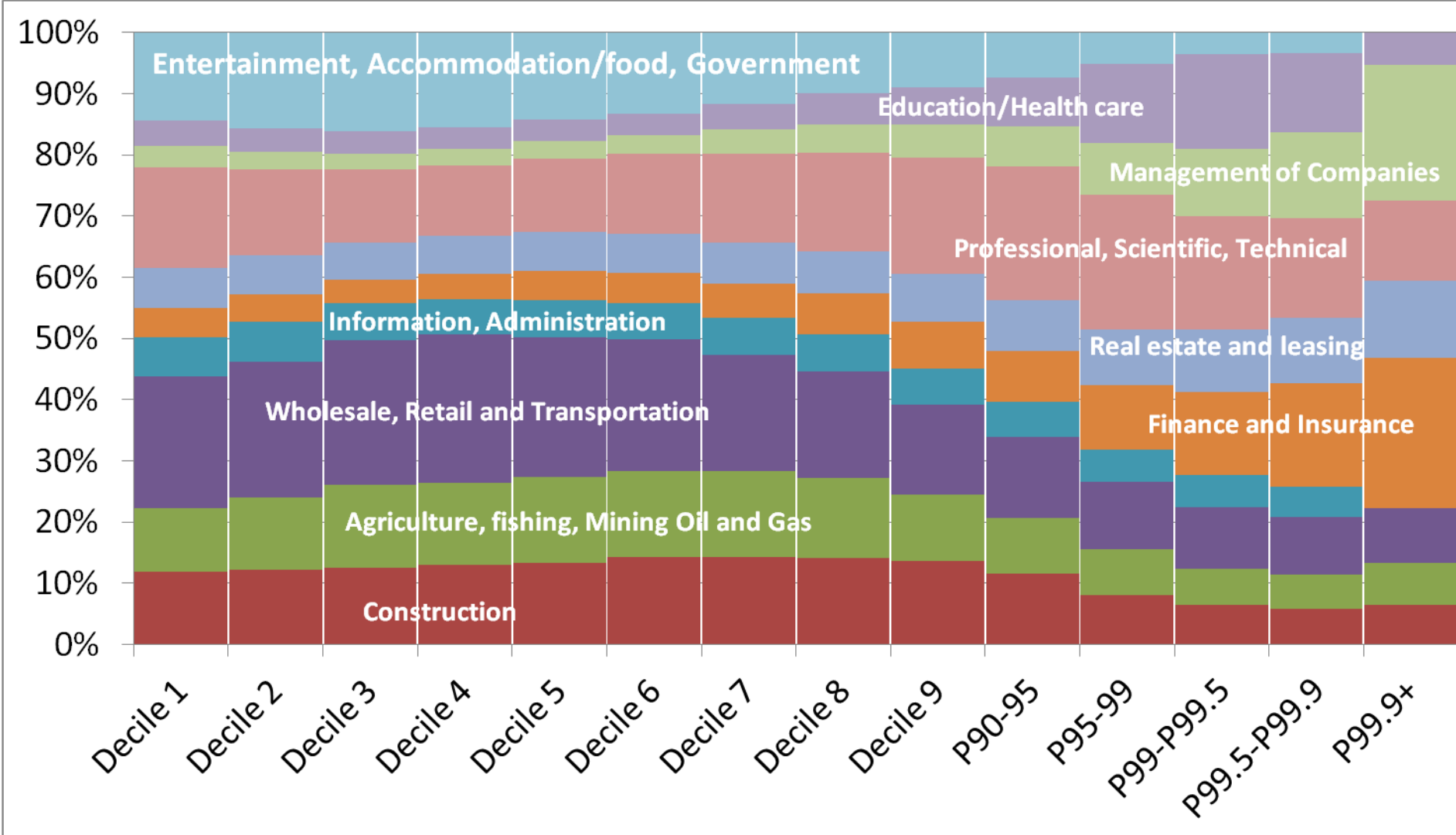


CCPC Ownership by City: Top 5%



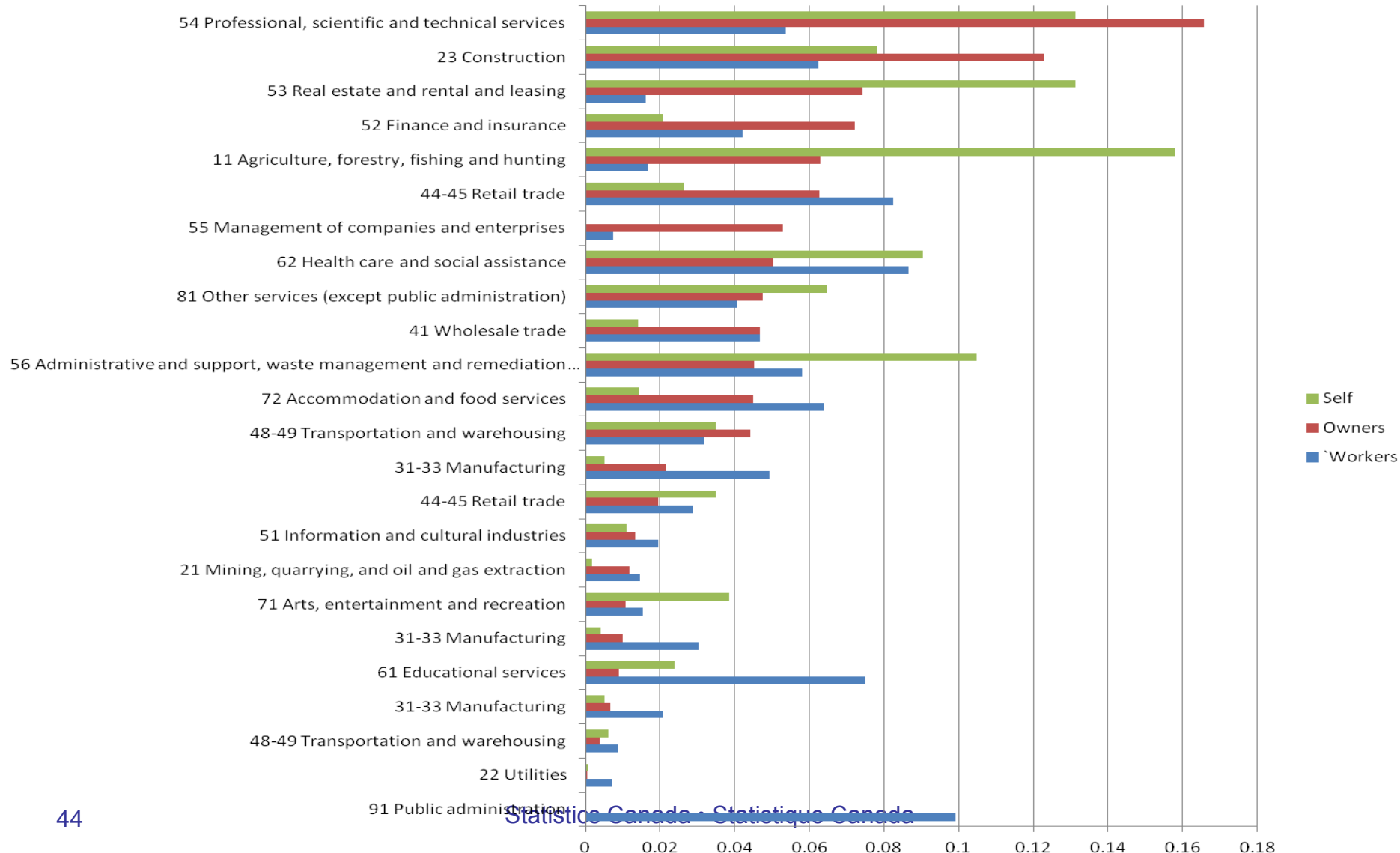


CCPC Ownership by T2 Industry





Distributions by 2-digit Industry





Distributions by 6-digit Industry

Distribution of owners within income group
NAICS(6) Industries with > 1% of filers

	All	Top 10	Top 1
Holding Companies	5.3%	9.0%	13.8%
Offices of Physicians	2.7%	6.4%	8.5%
Miscellaneous intermediation (Financial)		5.6%	
Lessors of non-residential buildings	2.6%	3.7%	4.8%
Computer systems design	3.6%	4.3%	1.6%
Management and management consulting		3.6%	
Financial Intermediation	3.4%		
Residential building Construction	3.3%	2.0%	1.3%
Portfolio Management	1.2%	1.8%	2.8%
Management Consulting	2.8%		

Distributions by 6-digit Industry

Distribution of owners within income group
NAICS(6) Industries with > 1% of filers

Holding Companies

Offices of Physicians

Miscellaneous intermediation (Financial)

Lessors of non-residential buildings

Computer systems design

Management and management consulting

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1.2%	1.8%	2.8%
2.8%		



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3.4%		
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2.8%		



Distributions by 6-digit Industry

Distribution of owners within income group
NAICS(6) Industries with > 1% of filers

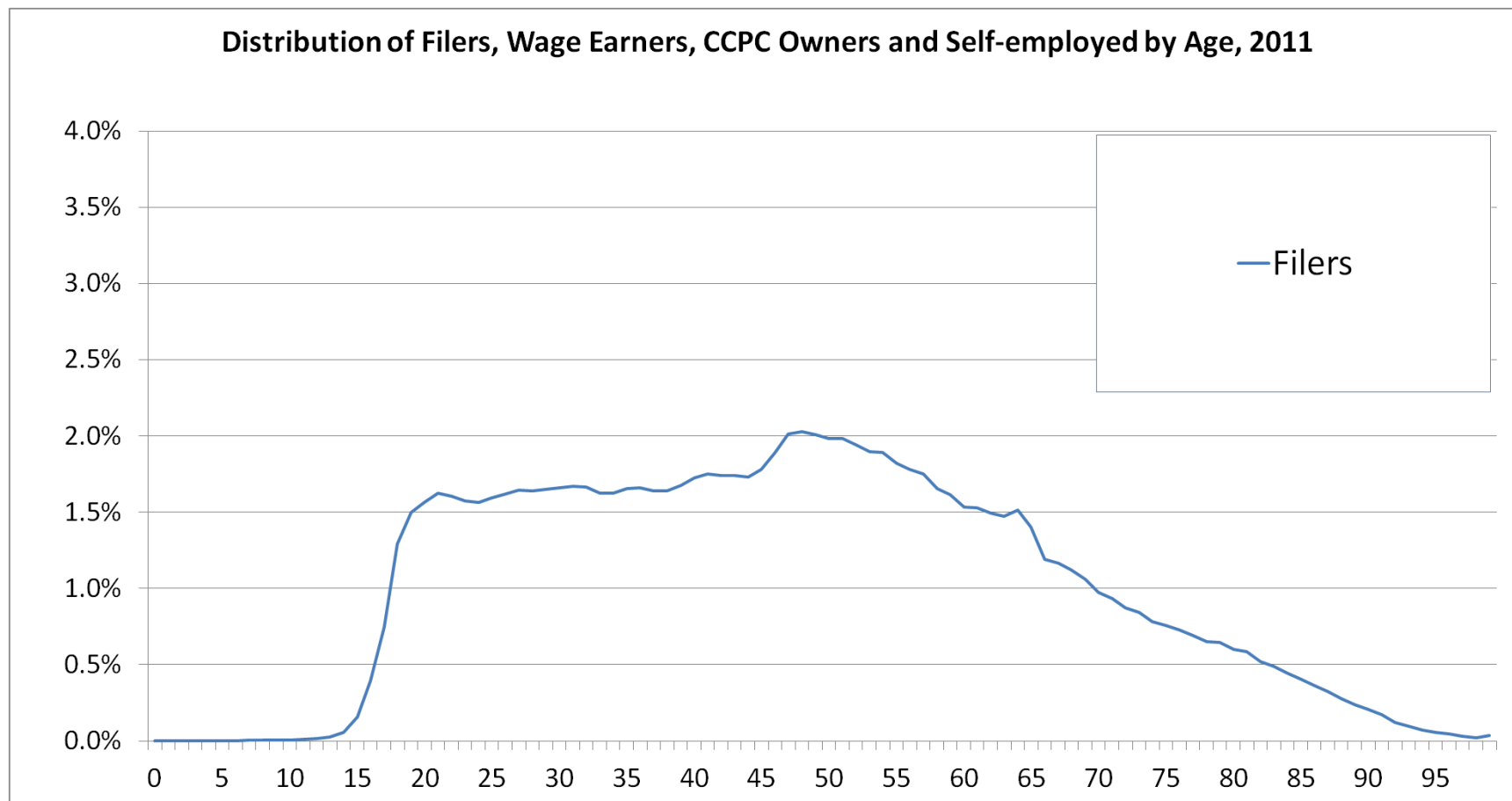
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Management Consulting	2.8%		

Industry: CCPC vs. workplace

- 61% of CCPC Owners who also receive wages have the same 2-Digit NAICS for both their CCPC and wage source
 - Highest rates of congruence
 - Manufacturing (76%)
 - Health Care and Social Assistance (76%)
 - Retail Trade (75%)
 - Lowest rates of congruence
 - Finance and Insurance (32%)
 - Real estate, renting and leasing (31%)
 - Management of Companies (16%)

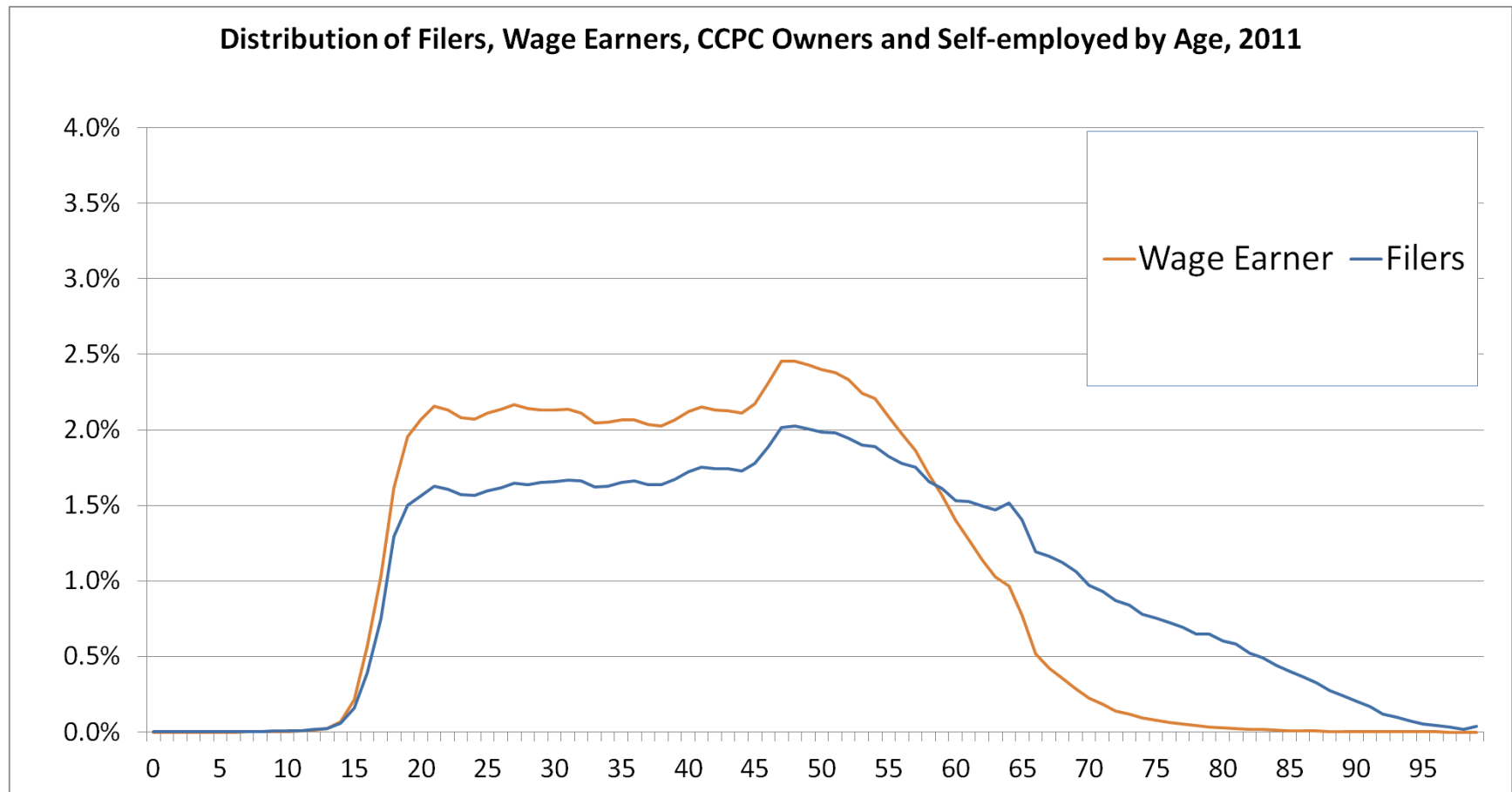


Age Distributions



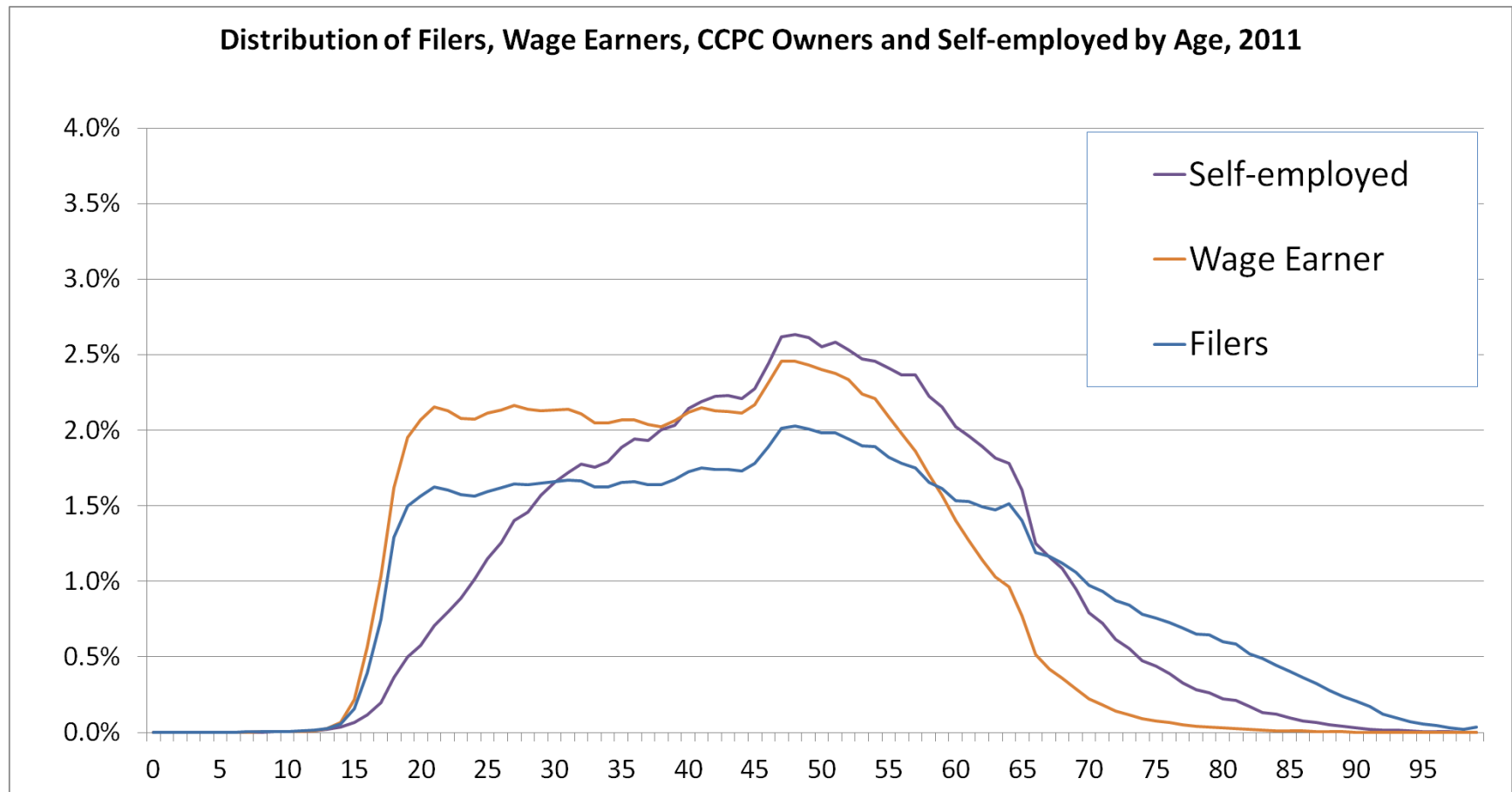


Age Distributions



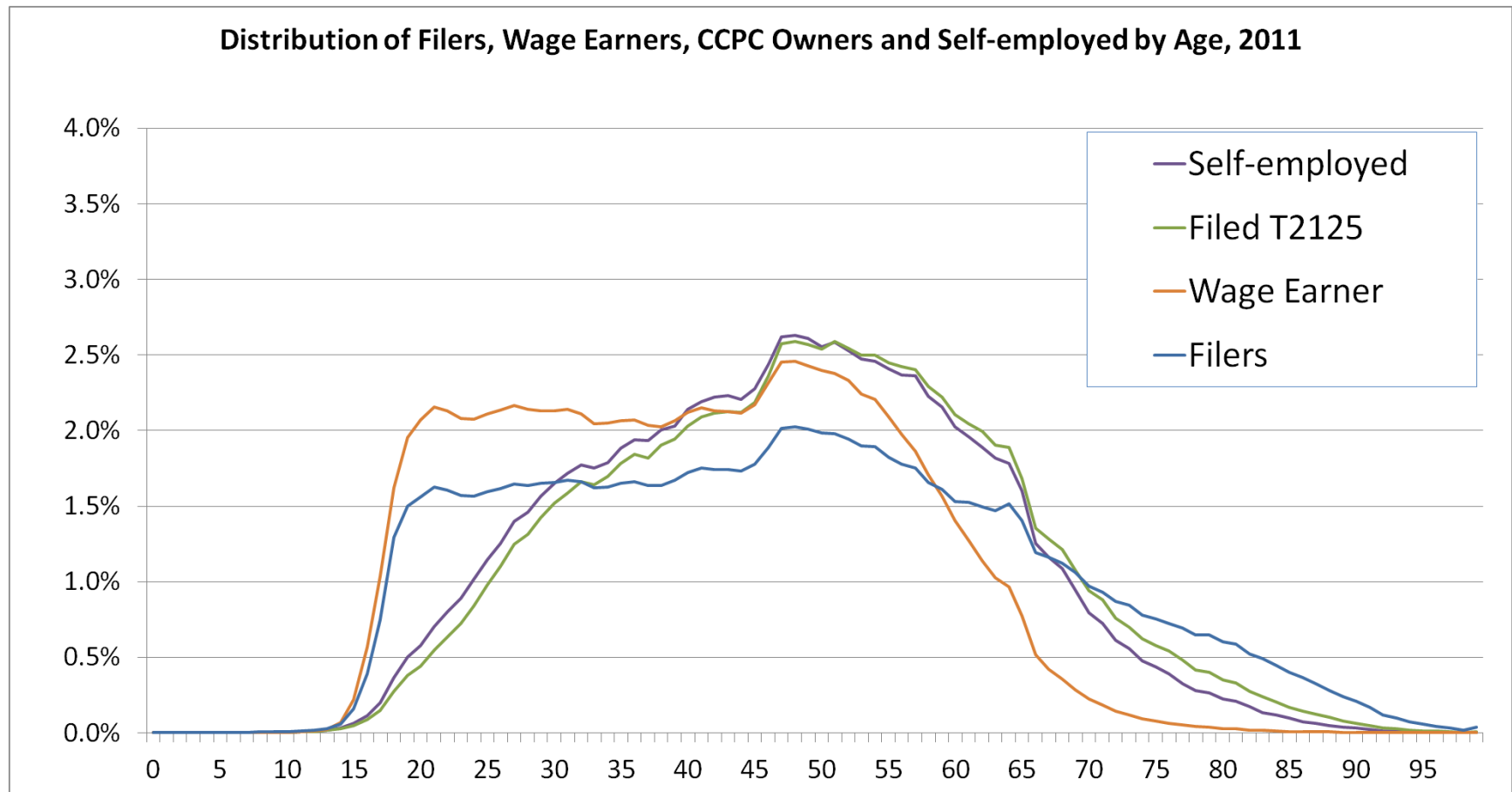


Age Distributions



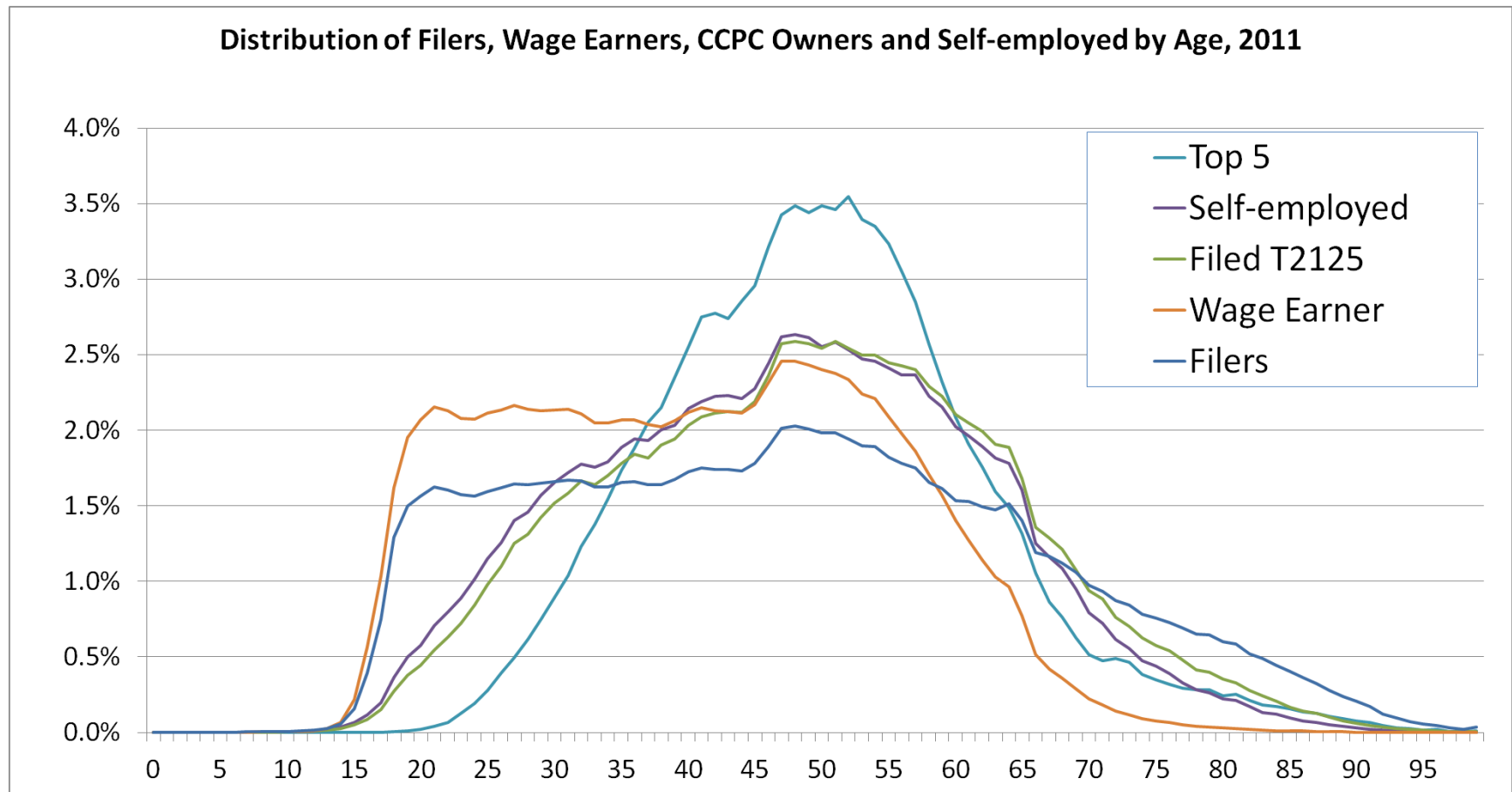


Age Distributions



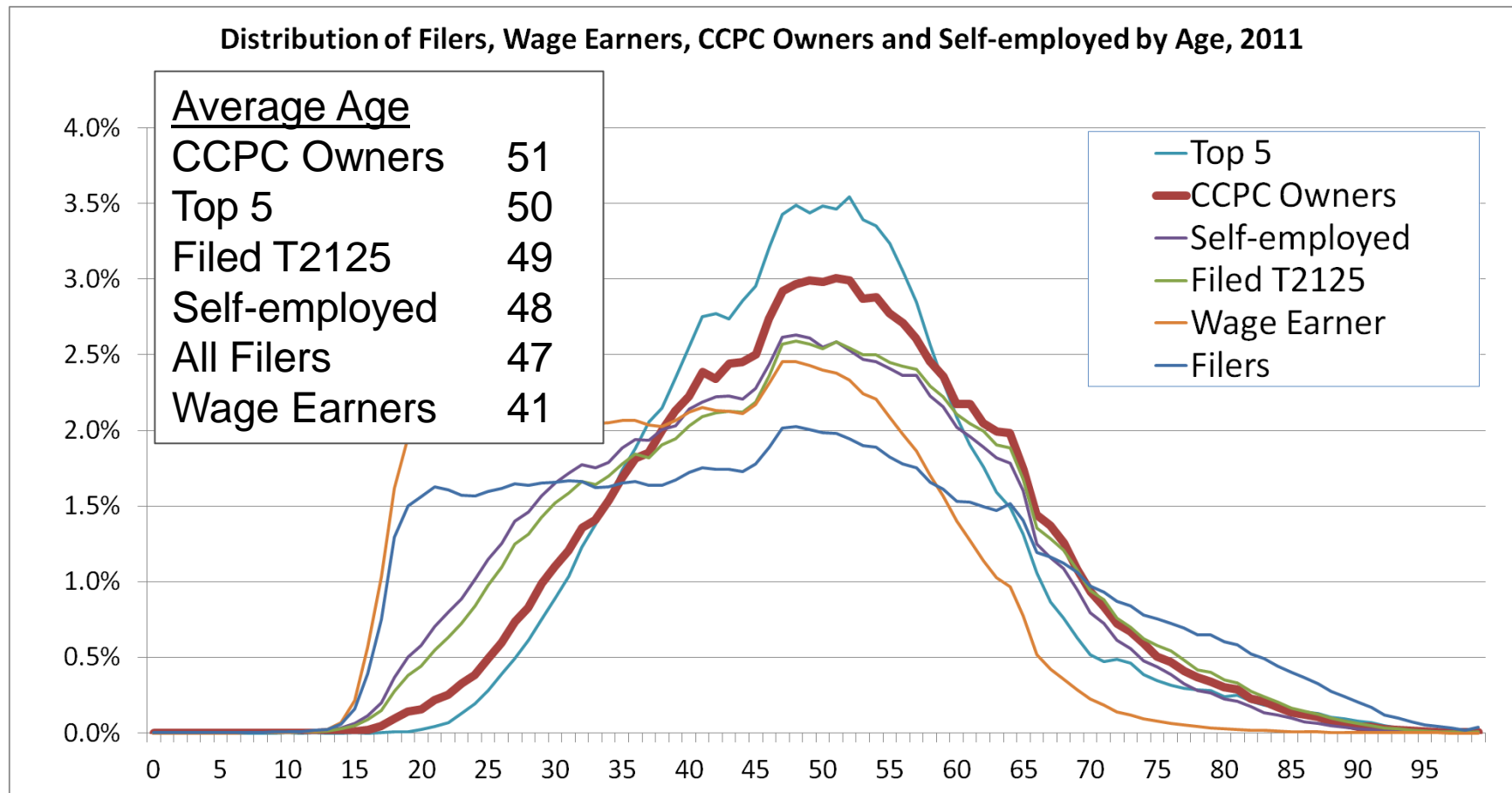


Age Distributions

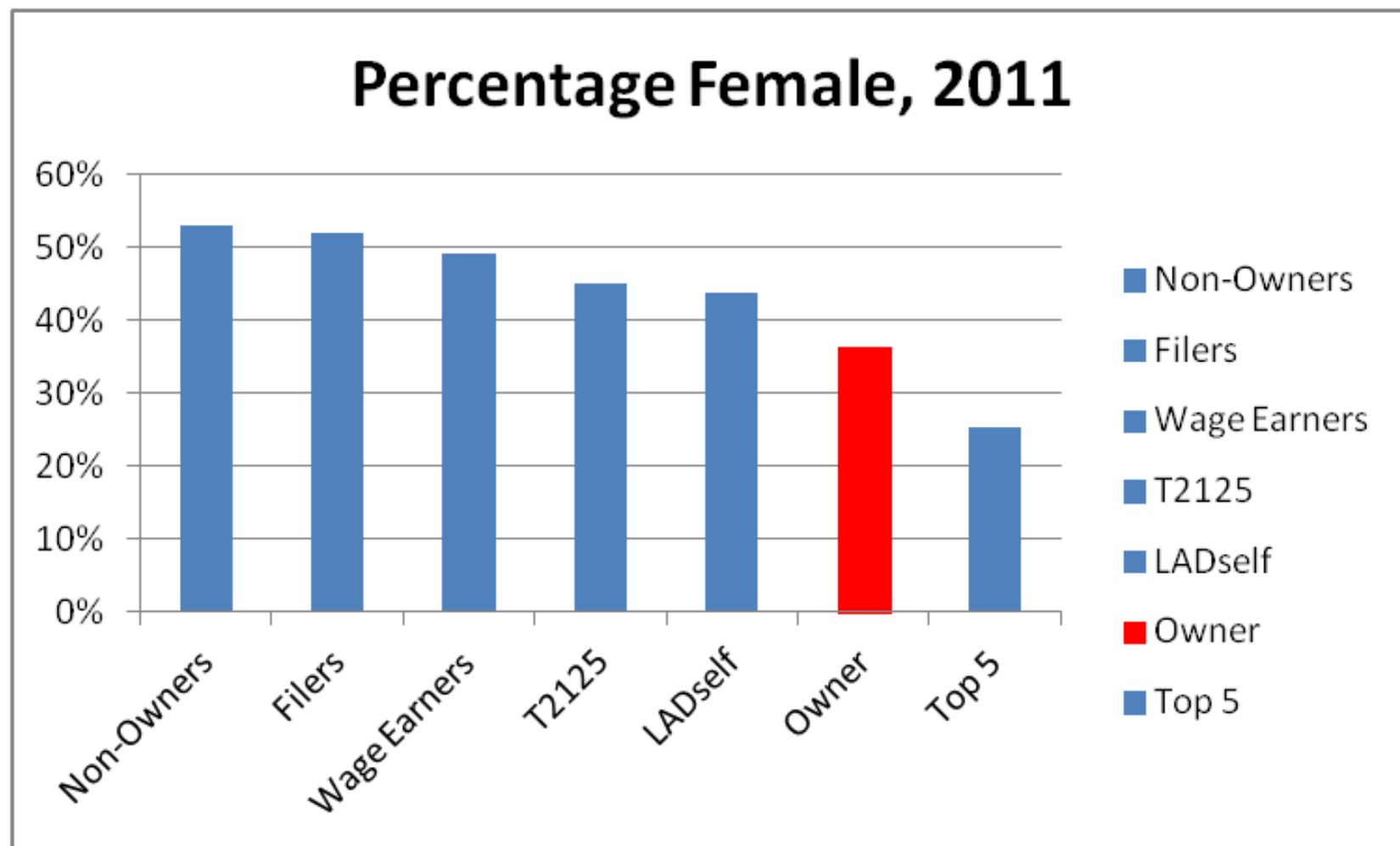




Age Distributions

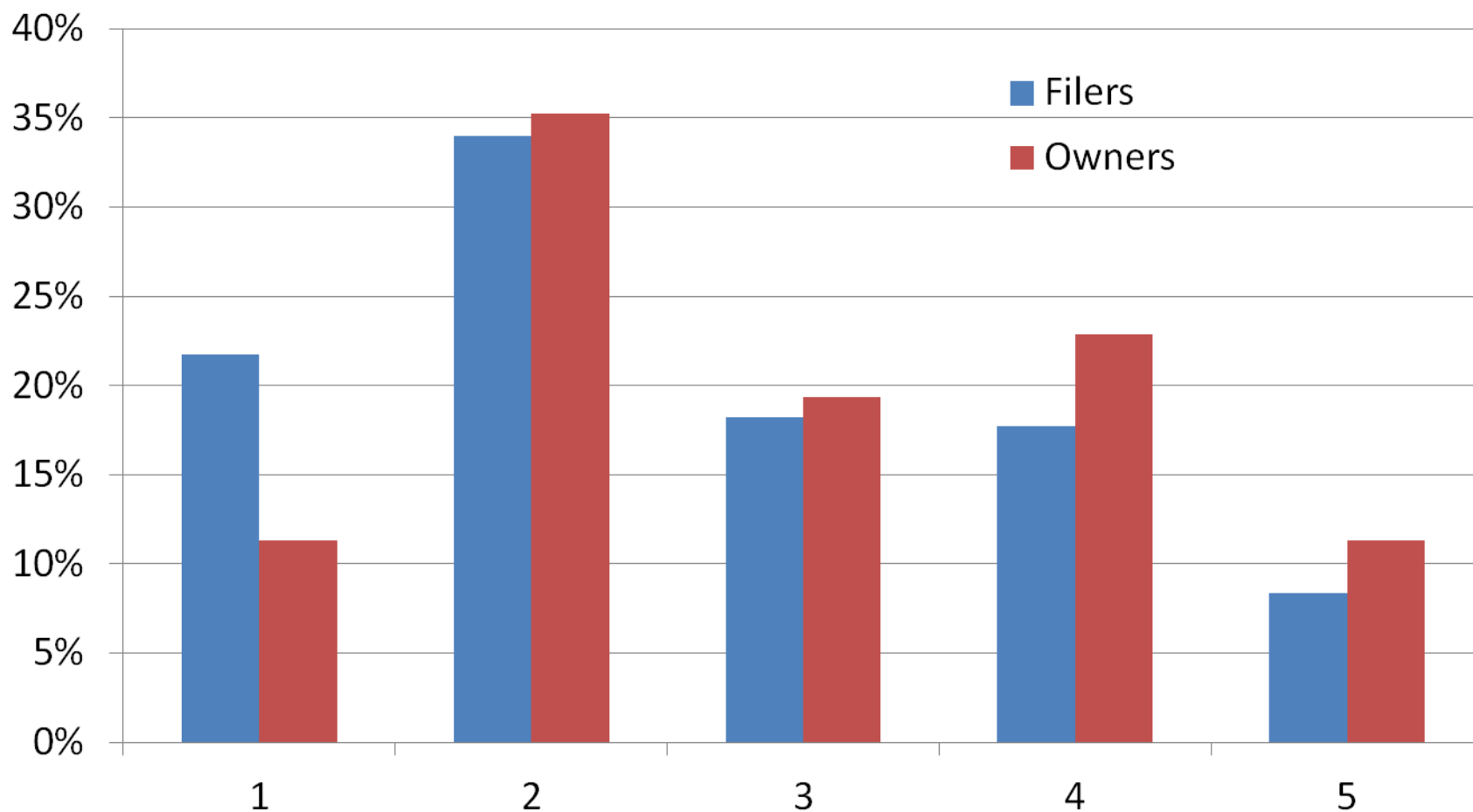


Gender





Distribution of Filers and CCPC owners by Family Size





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Impact on the distribution of income

FINDINGS

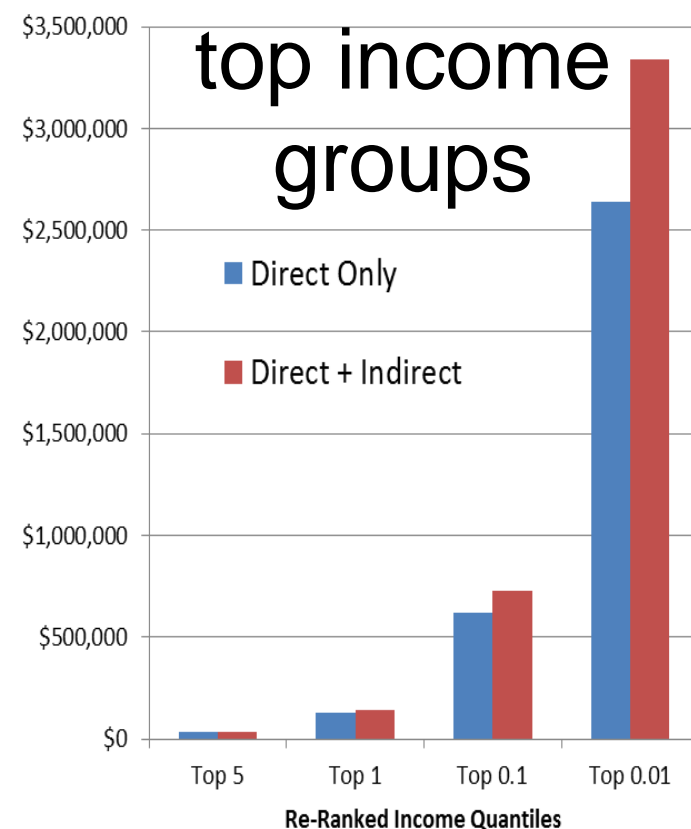
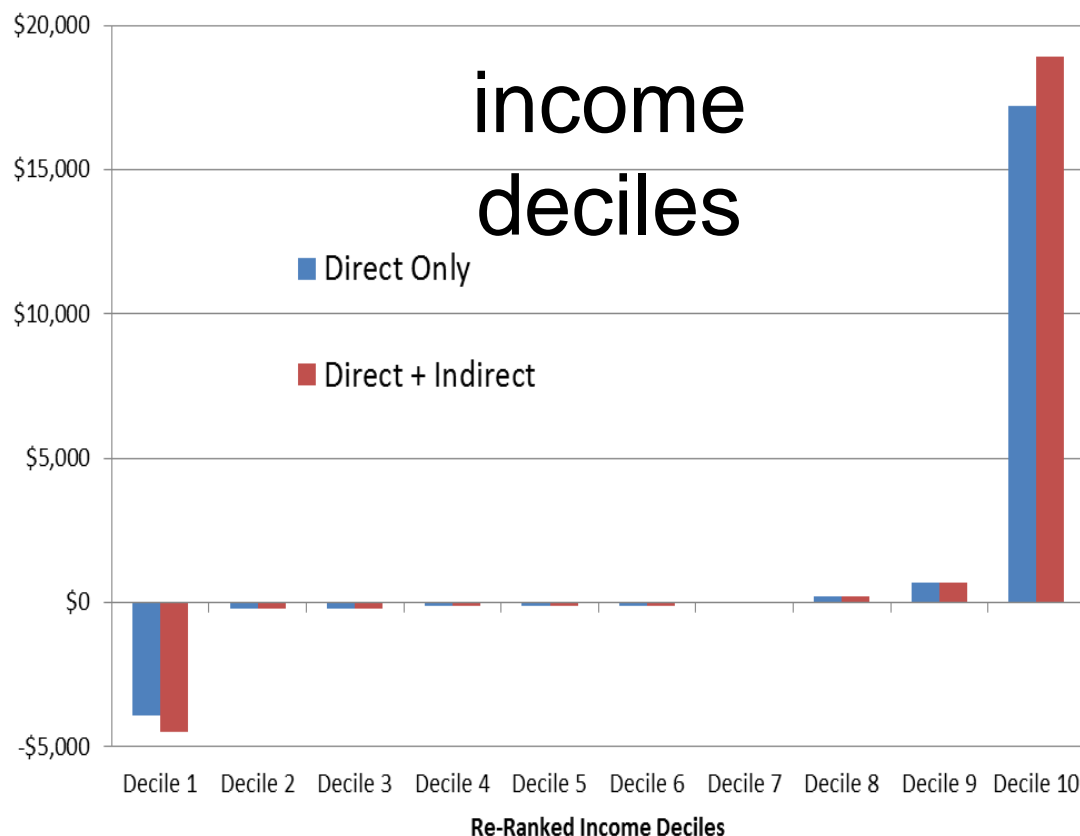


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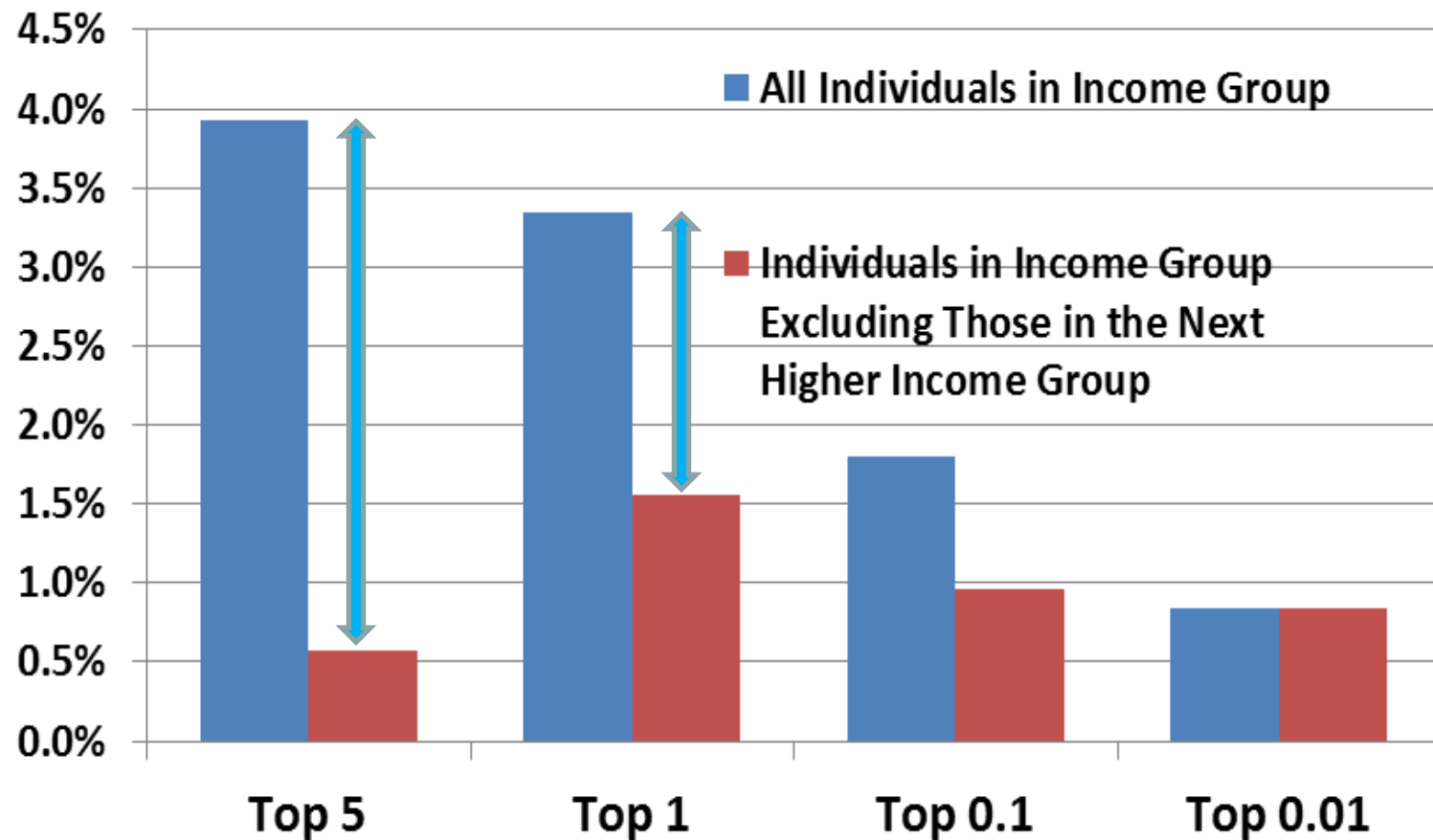
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Average Amounts of CCPC Income by Income Quantile, 2011





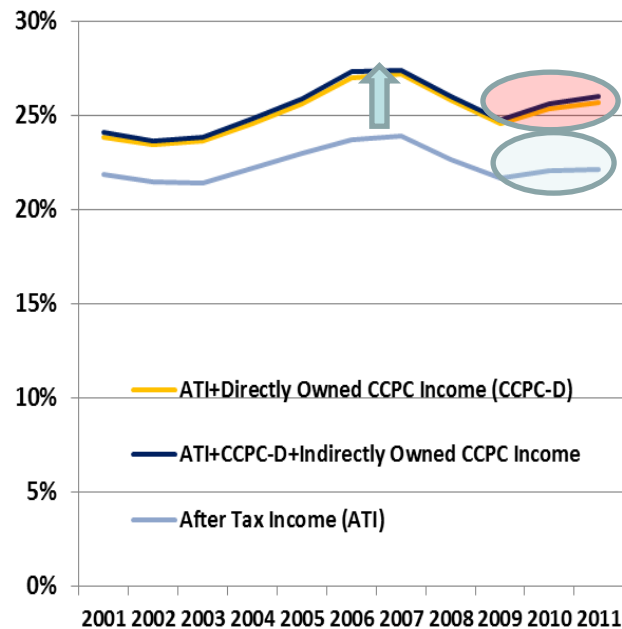
Changes in Top Income Shares from Inclusion of CCPC Income, 2011



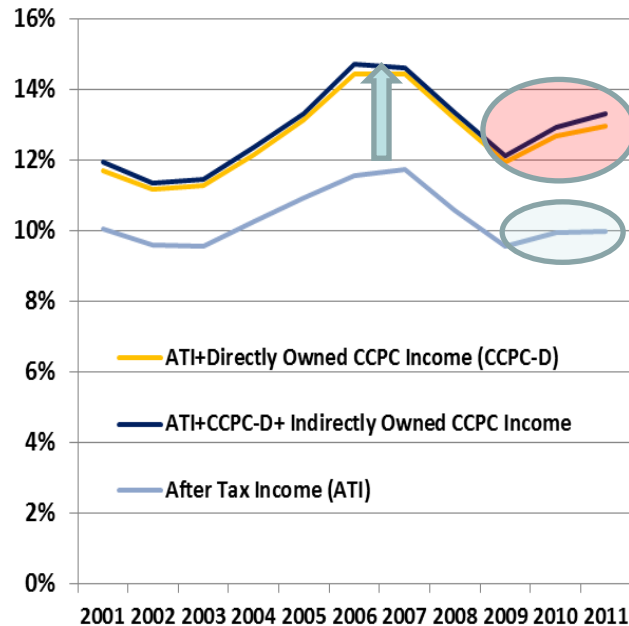


Trends in Top Income Shares by Income Definition and Top Income Group, 2001 to 2011

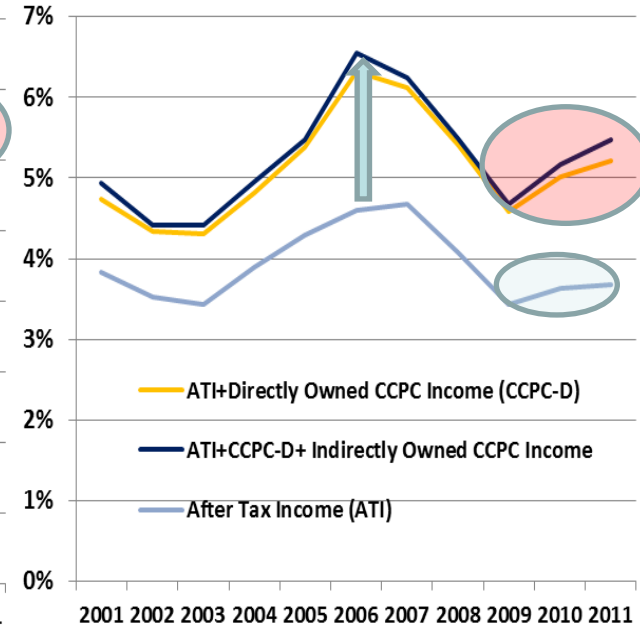
Income Shares of Top 5%



Income Shares of Top 1%



Income Shares of Top 0.1%





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Distribution of Earnings from CCPCs via wages and dividends

FINDINGS



CCPC Owners: aggregate sources of T4 and T5 income (Year = 2011)

T4 Income Source	VALUE (\$m)	PERCENT
From directly owned CCPC	\$ 40,138	48.9%
From family-member directly owned CCPC	\$ 944	1.1%
From other sources (LAD)*	\$ 41,054	50.0%
Total	\$ 82,136	100.0%
 Total LAD Population Estimate	 \$ 730,454	 11.2%
T5 Income Source	VALUE (\$m)	PERCENT
From directly owned CCPC	\$ 24,475	81.5%
From family-member directly owned CCPC	\$ 75	0.2%
From other sources (LAD)*	\$ 5,473	18.2%
Total	\$ 30,023	100.0%
 Total LAD Population Estimate	 \$ 41,776	 71.9%

Note: * Calculated as (LAD values – slip file values). LAD values will be understated in the case of late / missing filers, so these figures are understated. LAD population estimates generated using same sample restrictions as for owners: remove imputed and out-of-country filers.



CCPC Owner Summary Statistics: Family Types (Year = 2011)

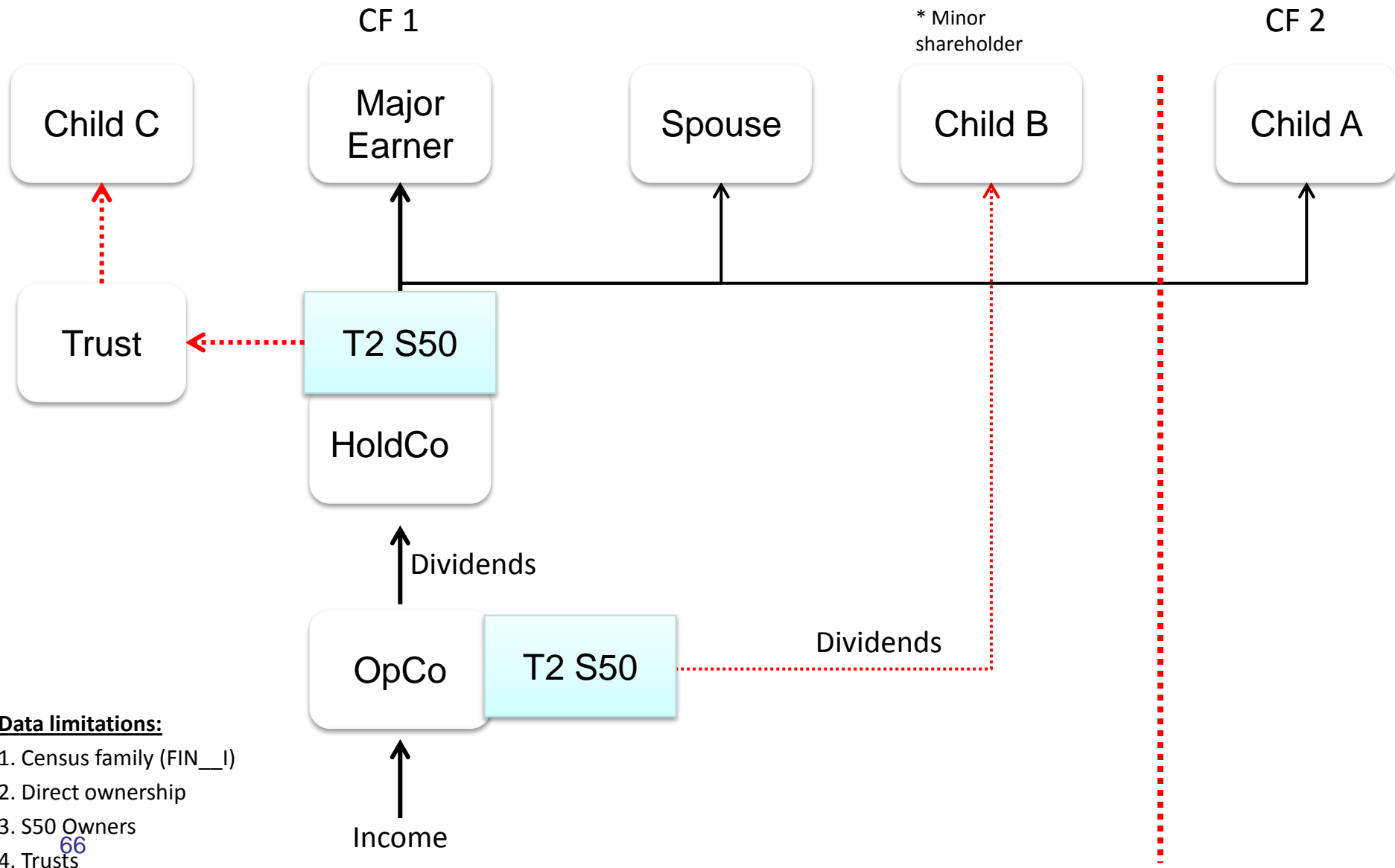
Owner Family Types	OWNERS		TAXFILERS
	Frequency	Percentage	Percentage
Unmarried, no children	214,600	13%	25%
Unmarried, with children	112,000	7%	18%
Married, no children	530,220	32%	26%
Married with children, no adult children	491,160	29%	20%
Married, with at least one adult child	211,465	13%	7%
Other	117,385	7%	3%
Total	1,676,830		

Note: adult children defined as being 19 years of age or older and still in Census family

Data: CCPC income within families

- **Important Concepts:**
 - **1. Census family:** all members of the same Census family are linked by a common ID variable. This variable is created using T1FF and other available administrative data.
 - **2. Direct ownership:** The first layer of CCPCs owned. We do not consider CCPCs indirectly owned further up a chain.
 - **3. Owners:** Those individuals who appear on the T2-S50 form as owning greater than 10% of the CCPC.
 - **4. Trusts:** Trusts (T3 data) can be shareholders of CCPCs and are set up to provide income to a beneficiary. They are excluded from our analysis.

Data: Structure and Limitations



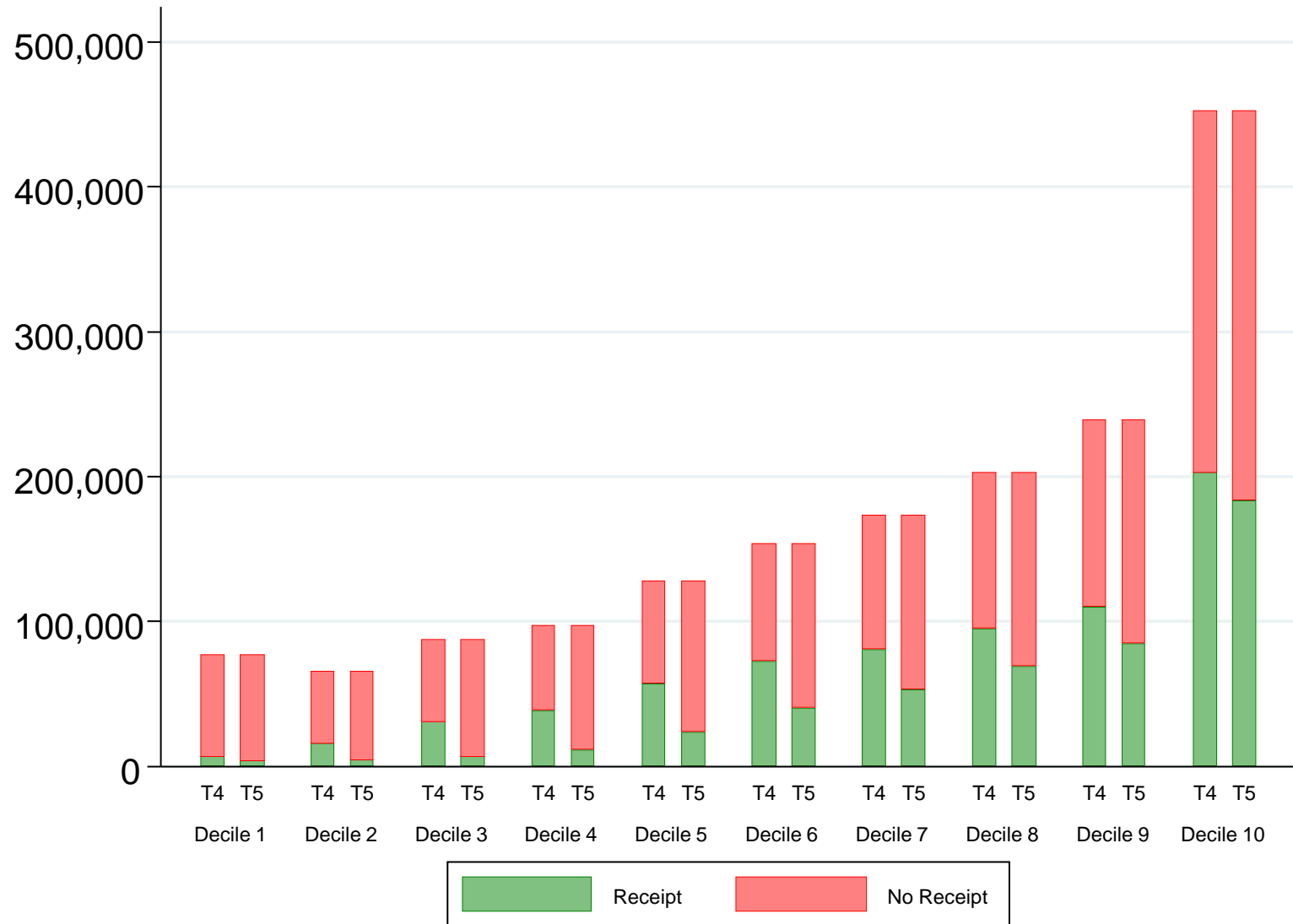
Conditioning on owner income (Year = 2011)

			Family members receive T4 ?		Percent of family receiving T4 income from OWNER CCPC
			Y	N	
S50 owner receives T4 from owned CCPC ?	Y	711,000	370,000	341,000	52.0%
	N	966,000	19,000	947,000	2.0%
	Total	1,677,000	389,000	1,288,000	23.2%

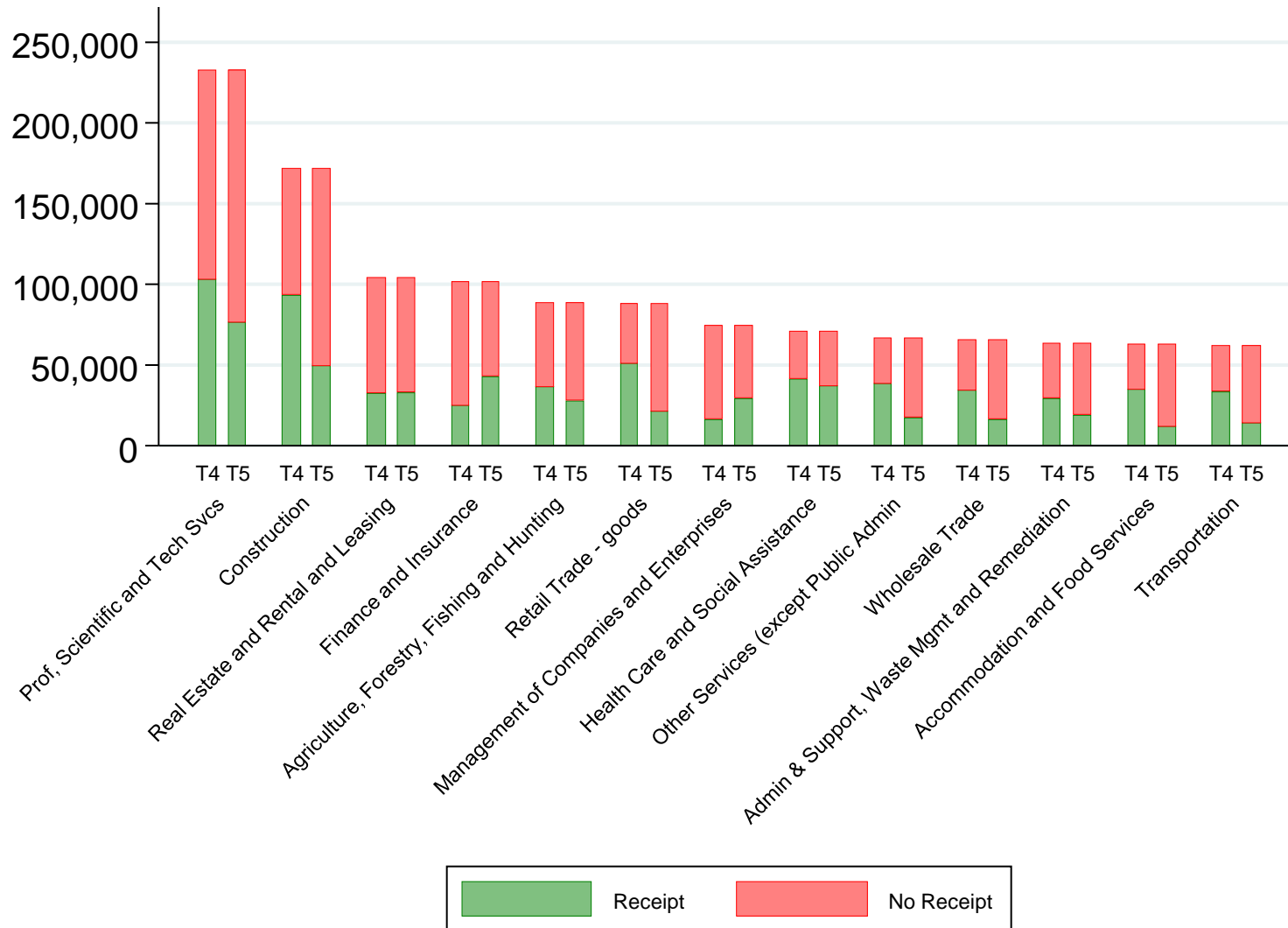
			Family members receive T5 ?		Percent of family receiving T5 income from S50 owner CCPC
			Y	N	
S50 owner receives T5 from owned CCPC ?	Y	480,000	202,000	278,000	42.1%
	N	1,197,000	12,000	1,185,000	1.0%
	Total	1,677,000	214,000	1,463,000	12.8%

		T5	
		Y	N
T4	Y	13%	29%
	N	16%	42%

Owner T4 and T5 receipts from own CCPC(s) by Income Decile



Owner T4 and T5 receipts by 2-digit NAICS of owner's highest income CCPC (Year = 2011)

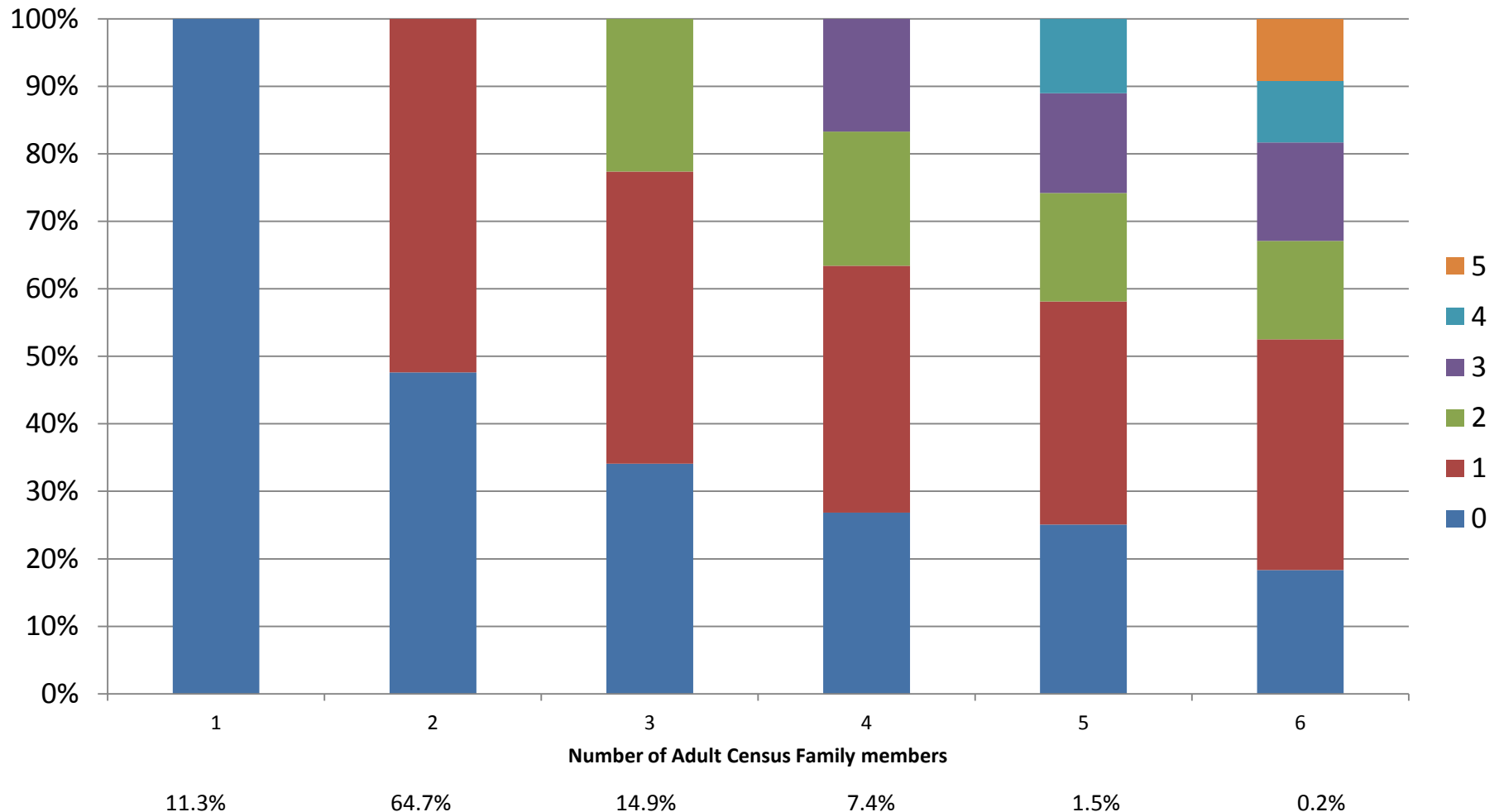


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 Note: NAICS 2-digit industries with less than 50,000 owners excluded for presentation purposes. Owners with missing NAICS excluded.
 Total sample excluded: 25%. Industry is of the CCPC (where owners own more than one) that has the highest net retained earnings in 2011.



Family Income Allocation: T4 (Year = 2011)

Number of Other Family Members Receiving T4 Income



Note: Adult family members defined as those in Census family who are 19 years of age or older. Family counts do not include the owner him/herself. Families of size 7 or greater excluded due to confidentiality restrictions.



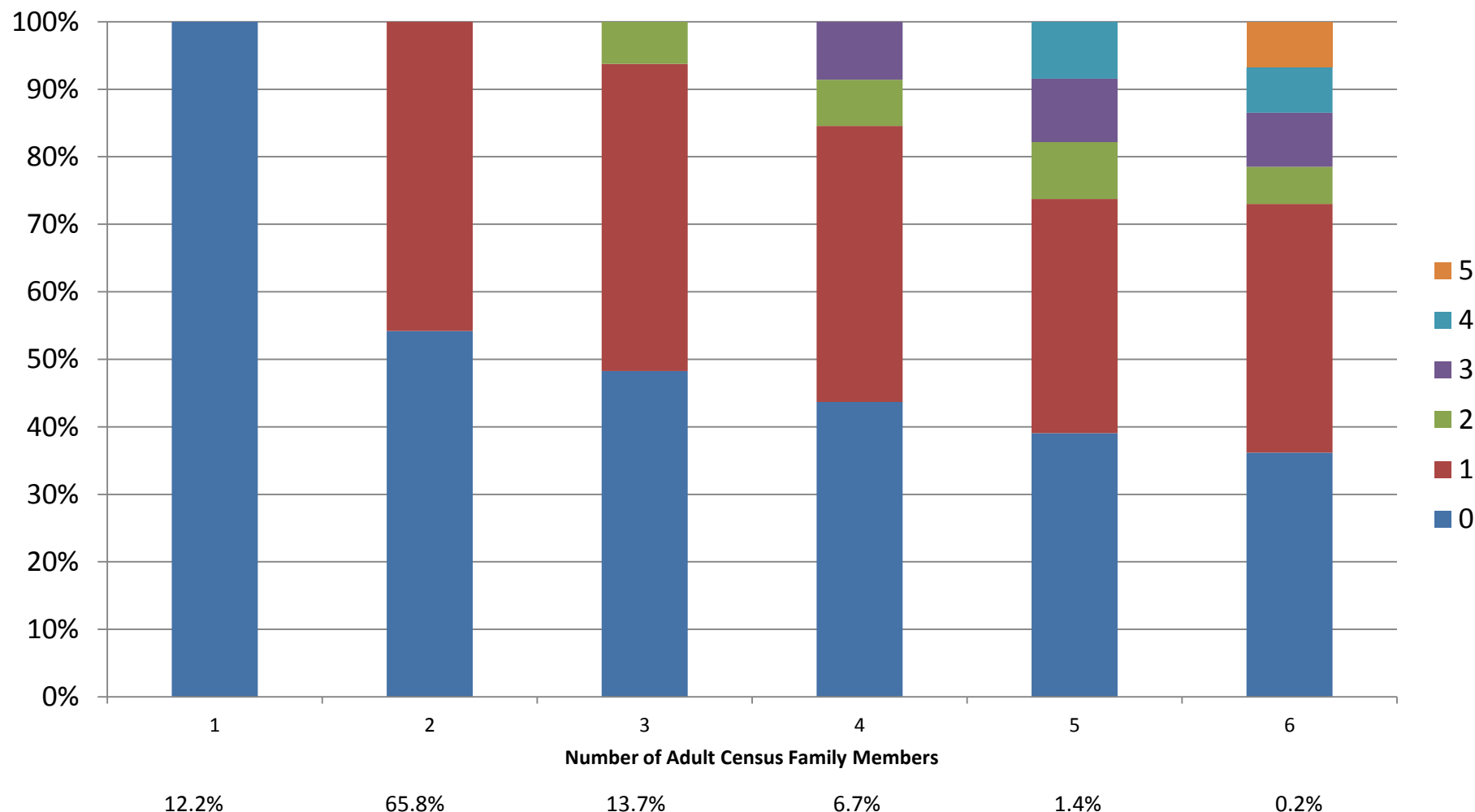
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Family Income Allocation : T5 (Year = 2011)

Number of Other Family Members Receiving T5 Income

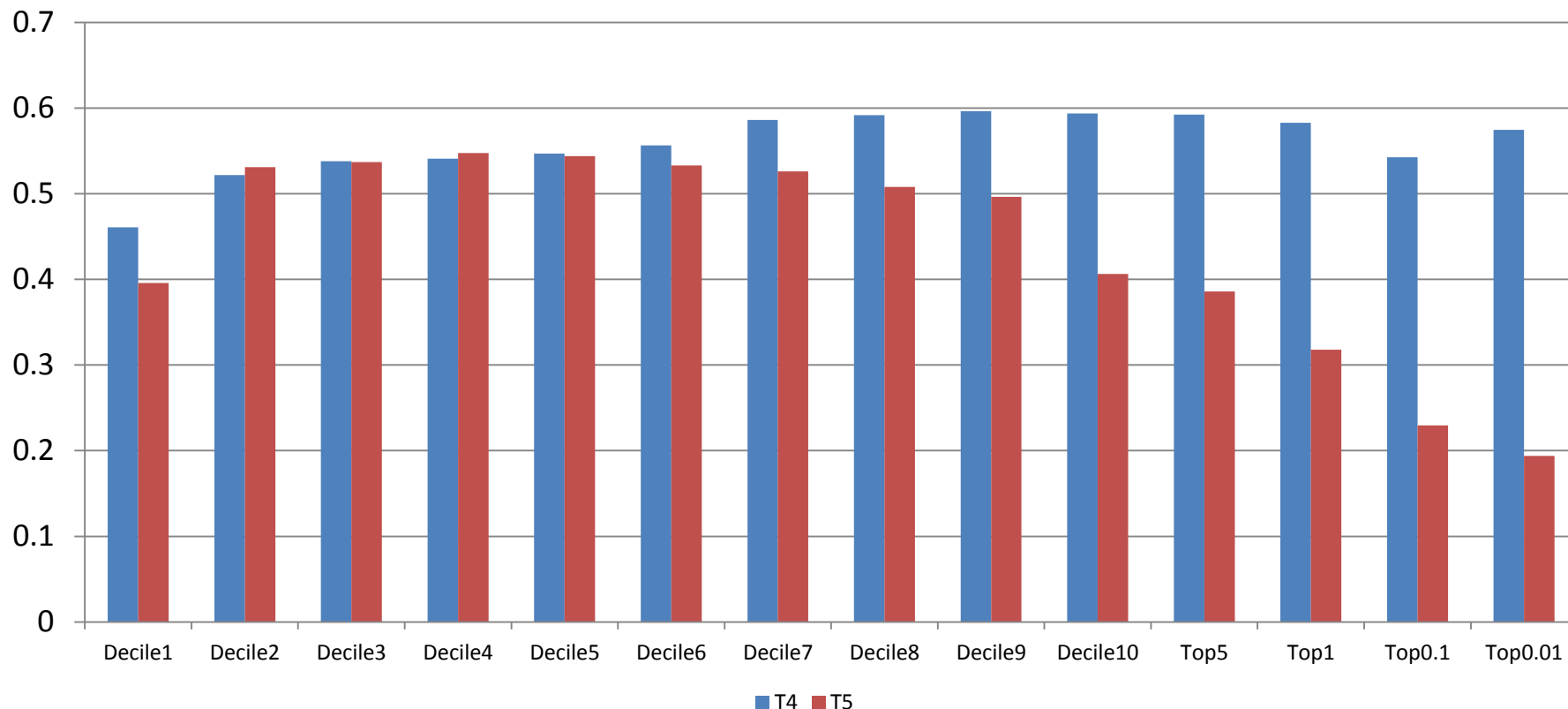


Note: Adult family members defined as those in Census family who are 19 years of age or older. Family counts do not include the owner him/herself. Families of size 7 or greater excluded due to confidentiality restrictions.



Family Income Allocation (Year = 2011)

Proportion of S50 Owners who have family receiving income from owned CCPC



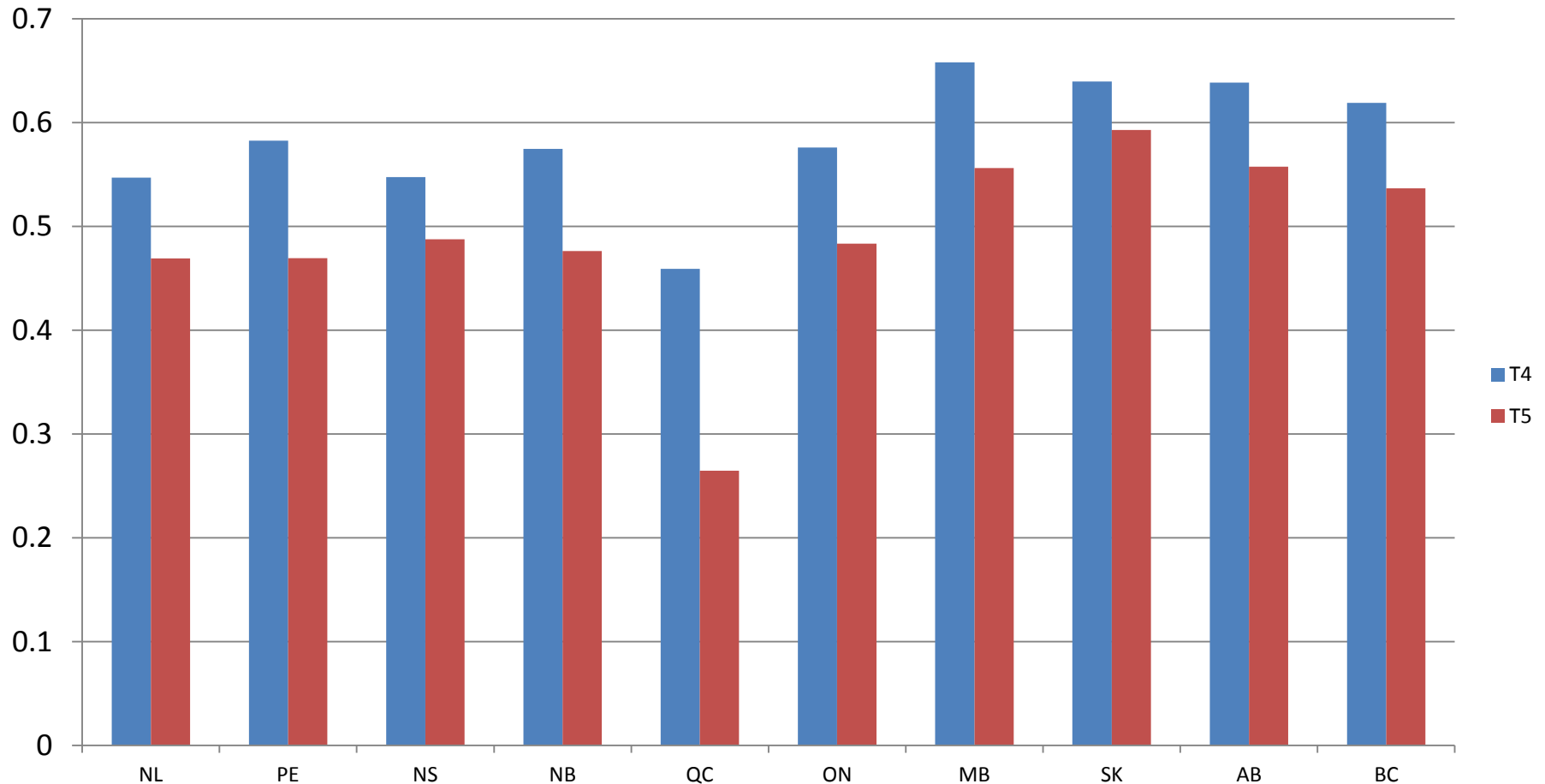
T4 SAMPLE	6,360	14,730	27,250	35,330	52,160	65,960	73,095	85,720	99,145	181,190	122,750	37,010	4,580	470
T5 SAMPLE	3,425	3,700	5,830	10,320	20,715	35,720	47,305	61,075	75,995	161,105	111,920	37,745	5,315	645

Note: Each sample is restricted to owners that pay themselves each type of income. Only families of size 2 or greater are included.



Family Income Allocation: by Province (Year = 2011)

Proportion of S50 Owners who have family receiving income from owned CCPC



Note: Each sample is restricted to owners that pay themselves each type of income. Only families of size 2 or greater are included.



Future work

- We have not yet modelled and tax implications of income splitting through CCPCs
- MacNaughton and Matthews (1999) estimated \$115m cost of not implementing “Kiddie tax”



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Professionals and CCPCs

FINDINGS

Statistical Methods

- Caveat – using NAICS \neq occupation; but close
- We have an excellent natural experiment
 - for lawyers, a Canada-wide change from CRA with gradual diffusion
 - for doctors, an Ontario-specific change in 2005
 - for other kinds of small businesses, e.g. farms and restaurants, no particular change = control group
- Could do multivariate regression but straightforward graphs tell the story

Lawyers and the Small Business Rate

- Consider a law firm with k partners
- In principle, the firm would be eligible for one small business deduction, hence able to receive up to \$500,000 that is taxed at a low rate
- So each firm could receive up to $\$500,000/k$ at the low small business tax rate
- However, law firms have been allowed by CRA, via advance tax rulings, to restructure themselves to consist of one central firm + one CCPC for each law “partner” – actually a separate legal entity selling each individual lawyer’s services
- Result: law “firm” is able to receive up to $k \times \$500,000$ taxed at the low small business tax rate



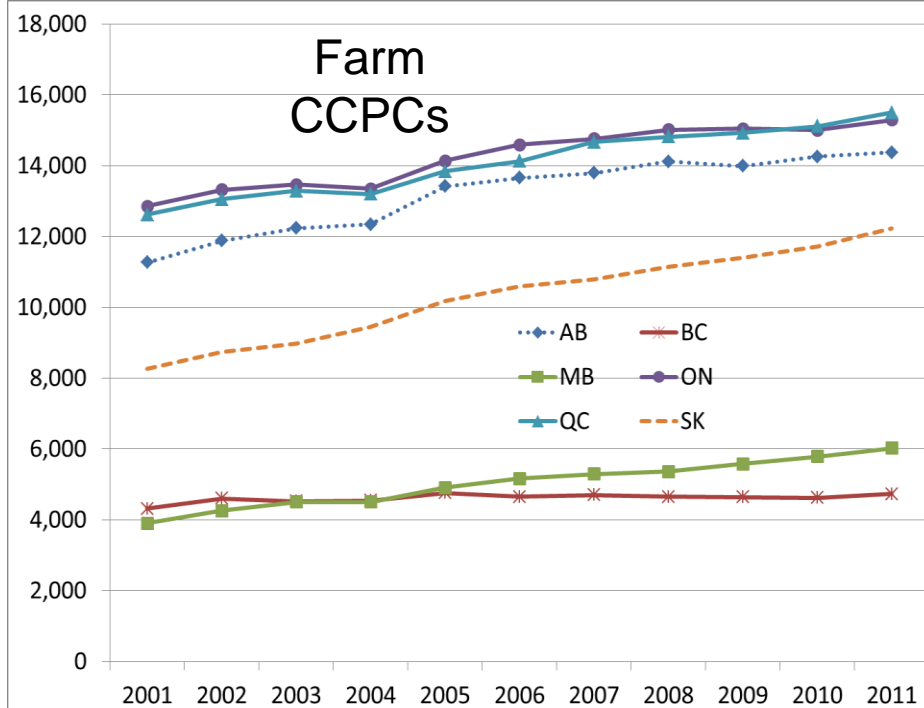
Doctors and the Ontario Budget 2005

PROFESSIONAL CORPORATIONS

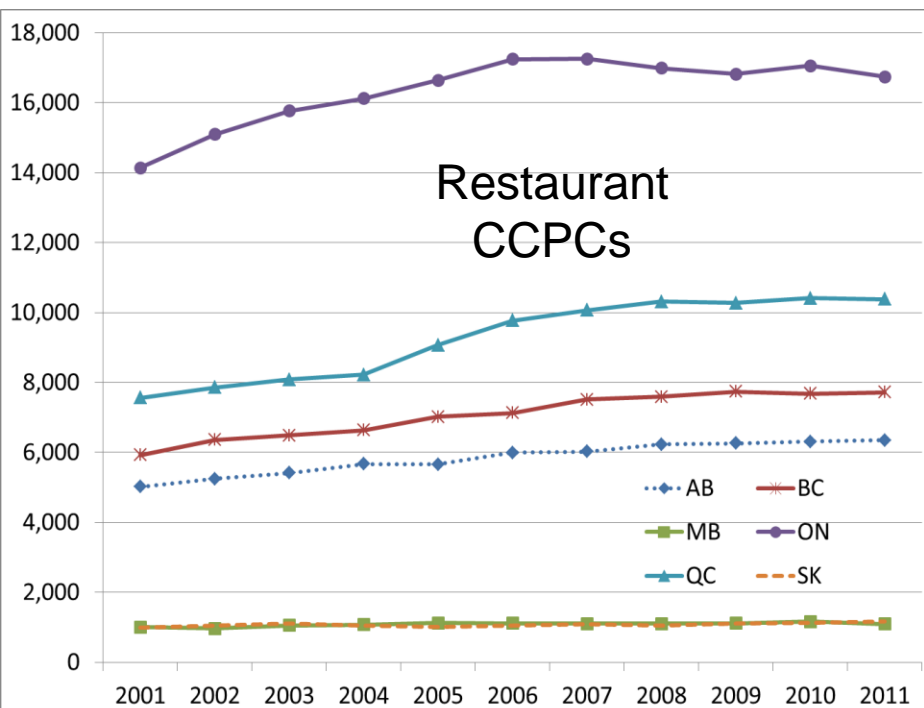
In 2001, the right to incorporate was extended to all regulated professionals. Under existing provisions, non-members of a profession cannot own shares in a professional corporation. Recent negotiations with the Ontario Medical Association have resulted in the government's commitment to extend the share structure of physician professional corporations to include non-voting shares for family members. The government is also proposing to implement this change for dentists who operate their practices through a professional corporation.

(Paper C, Details of Revenue Measures, Ontario Budget, 2005)

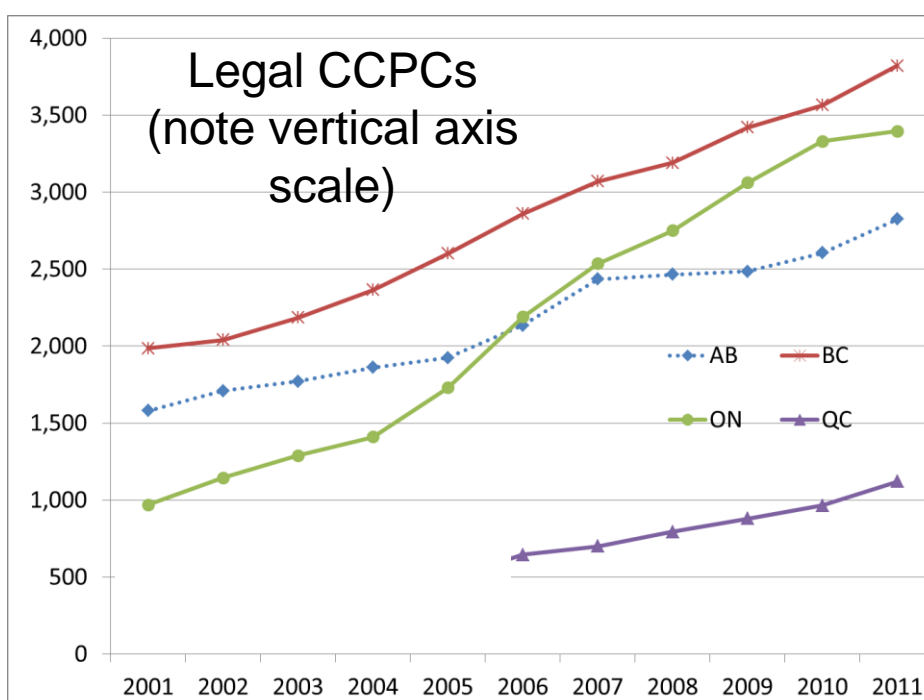
Farm CCPCs



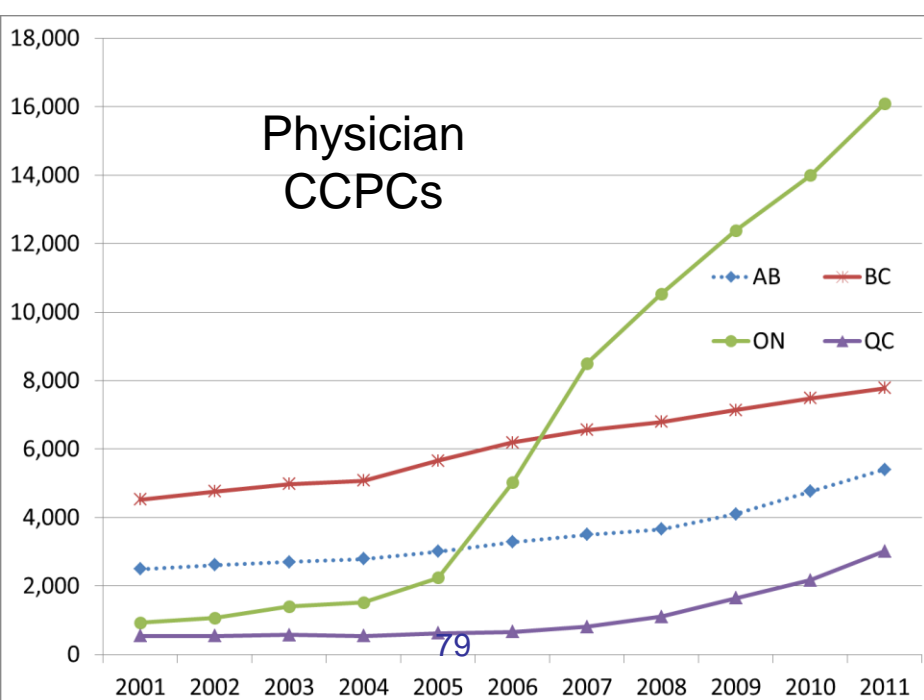
Restaurant CCPCs



Legal CCPCs (note vertical axis scale)



Physician CCPCs





- Income splitting is nothing new; via CCPCs it has been available for decades
- This kind of income splitting is known primarily to individuals with good tax advice, and the ability to incorporate their labour services



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SUMMARY

Summary

- 1.7 Million owners of >10% Share of a CCPC
 - 6.4% of filers
 - 72% owners earn under 61K in 2011
 - Over 70% of Top 0.01 own CCPCs
- Nearly 1/3 of owners have self-employment
 - More overlap at higher incomes
 - Similar industries as owners
- Higher rates of ownership in western provinces
 - Ownership not correlated with city size

Summary

- Ownership in the financial management and professional industries is more prevalent at higher incomes
- Owners are on average older and more male than wage earners or self employed but younger and more female than high income Canadians

Summary

- Omission of beneficially owned CCPC income biases our understanding of income inequality in Canada
 - high incomes are higher by one-third (top 1%) or more
 - likely an under-estimate
- The financial advantages of income splitting through CCPCs are difficult to estimate yet they represent a real tax expenditure

Summary

- This analysis has made use of CRA microdata
- To our knowledge, no one has used these data at this level of detail
- However, these data have critical gaps – especially regarding share structure and ownership – e.g. classes of shares, voting or non-voting, participating or not
- Still, the data are of sufficient quality, and the questions being addressed of sufficient importance, that valuable insights have been obtained