Ottawa to rein in income 'sprinkling' by wealthy Canadians

Daniel Leblanc -The Globe and Mail

Ottawa has unveiled a series of new measures to rein in the ability of high-income Canadians to use private corporations to reduce their tax bills, including those who pay out dividends to family members in lower tax brackets.

The federal government is not enacting the measures immediately, but instead is launching consultations in the lead-up to final proposals in coming months. The government hopes to recoup at least $250-million a year with the proposed changes.

The proposed moves are expected to spark an outcry among various professional organizations in the country, but the government said they are necessary to stop a growing trend toward the use of private corporations to avoid paying taxes.

There has been an explosion in the number of private corporations in Canada in recent years, with many non-salaried individuals capitalizing on the 37-point spread between the top federal-provincial income tax rate and the combined federal-provincial small business rate.

The government is estimating that 50,000 families across Canada currently benefit from income sprinkling.

"Currently there are signs that our system isn't working as well as it should, specifically when it comes to private corporations. There are worrying trends. There is evidence that some may be using corporate structures to avoid paying their fair share, rather than invest in their business and maintain their competitive advantage," Finance Minister Bill Morneau said in a statement.

The first of three draft measures would curtail the ability of high-income Canadians to "sprinkle" income to family members, such as their children and spouse who are in lower tax brackets.

In one example provided by Finance officials, an individual making $220,000 a year could reduce his or her tax bill by $35,000 by redistributing about $100,000 to family members.

The new rules would ensure that income from these types of corporations would be taxed according to the highest bracket if it is not deemed to be "reasonable" based on the individual's contribution to the corporation.

"Current rules do not fully respond to many income sprinkling strategies," said one Finance document.

The second proposed measure would harmonize the treatment of "passive" investment portfolios. Under the current system, high-income Canadians can benefit from a more favourable taxation rate for income derived by stocks and real-estate investments when the investment is held in a private corporation. The proposed measure would not be applied retroactively, but rather to future investments.

The third proposed measure would limit the ability to convert a private corporation's regular income into capital gains, given that only half of capital gains are included in a taxpayer's income.