Business Owner Comparison to Employee - $150,000 Income

On July 18, 2017, the Department of Finance issued a document, “Tax Planning Using Private Corporations”. The federal government stated in that document that its goal was

*“Putting an end to tax planning strategies involving the use of private corporations is part of the Government’s ongoing actions to close **loopholes** and end tax planning strategies that give **unintended** advantages to some high-income earners at the expense of other Canadians.”*

Subsequent to the release of this document, numerous changes have been made to the original proposals, with the latest changes being announced in the 2018 Federal Budget in February.

Minister Morneau has said that these measures are “Part of our goal in making sure our tax system is fair.”[1]

In the July 18 proposals, there were examples used to justify why the government felt the changes needed to be made. One such example compared the taxes paid by an employee earning the same income as an incorporated business owner making the same income. The example is reproduced below.

Sprinkling income using a private corporation
Jonah and Susan are neighbours living and working in Ontario. Jonah and Susan live with their spouses and children who have no significant sources of income, other than as described below. Although Jonah and Susan each earn $220,000 in 2017, Susan’s household pays about $35,000 more tax than Jonah’s household. This is because Susan earns $220,000 as an employee. As an individual with $220,000 in employment income, she pays about $79,000 in income tax for the year.

Jonah has an incorporated consulting business that earns $220,000 before taxes and salary. Jonah provides the consulting services for the corporation. The corporation qualifies for the small business deduction in respect of its income from the business. Jonah owns the voting shares in the corporation. Jonah’s spouse and two children, ages 19 and 21, also own shares in the corporation, for which they paid very little. The corporation pays Jonah $100,000 in salary, and pays its remaining after-tax profits in equal amounts to the spouse and children as dividends. The dividends are taxable income of the spouse and children.

After accounting for corporate income tax, taxes on Jonah’s salary, and dividend tax credits claimed by the spouse and children, about $44,000 in total tax is paid on the

[1] December 13, 2017 Canadian Press

$220,000 earned in the year through the corporation and distributed to Jonah's family—$35,000 less than the amount of tax paid by their neighbour, Susan, on the $220,000 she earns to support her household.

The above comparison has a few serious issues.

- It is misleading because it only looks at the taxes paid at a point in time. That point in time happens to be when the business owner is able to split income with his university age children. This window of income splitting with children is usually between ages 18 – 24, so it is a very small window. Yet, this is the time the government chose to look at for purposes of making their point, when the tax discrepancy will be the greatest.
- The comparison between the employee and business owner is incomplete. The example completely ignores the additional benefits employees receive from employers over and above salary. These are benefits the business owner would need to fund from his earnings. These additional benefits would include
    - Employer contributions to pension, CPP, EI, employee benefits, training and continuing education, membership fees/dues.
    - Paid vacation, statutory, professional development and sick days

The purpose of the following analysis is to accurately compare an employee to an incorporated business owner by looking at the outcomes through a lifetime, instead of a point in time, and by including those benefits an employee receives from an employer.

Situation

Sara is an incorporated doctor. Her neighbour, Brent, is an executive. Today is the first day for each of them in their new jobs. They are both 35 years of age and live with their spouses. They have no RRSPs or other investments as they have been paying down debt and no other sources of income. They both plan on working for 30 years until they reach age 65.

Brent earns a $150,000 salary, indexed 2% per year. He is a member of a defined contribution pension plan. It is a 5%/5% plan where he will contribute 5% of earnings to the plan and his employer will contribute 5% total to the pension plan and a non-registered investment for any amount above the maximum allowed by regulation. He will also receive employee benefits including group disability and life insurance, as well as medical and dental coverage. He shares the cost of these 50/50 with his employer. He will also receive four weeks paid vacation, one week of professional development and statuary holidays.

Sara and her spouse each own 50% of her company. Earnings of Sara's company are $150,000 before Sara pays herself any compensation. This is also indexed 2% until retirement. She has no pension plan or employee benefits at this time. $5,000 will be used to acquire benefits similar to what Brent will be getting from his employer. Sara will take a dividend from her corporation to support her family's lifestyle and the remainder will accumulate inside her company.

Brent had his financial advisor prepare a financial plan based on the above assumptions. Investment assumptions are 7.5% for equities and 3.5% for fixed income with an asset allocation of approximately 60% equity, 40% fixed income. Therefore, the before tax return will be 5.9%, based on the above returns and asset allocation. The plan has determined that he can afford a $140,000 lifestyle indexed at 2% until death. For comparative purposes, it is assumed that Sara will have the same $85,000 lifestyle indexed at 2% until death.

Impact of Changes on Business Owner (3 Scenarios)

- Old Rules
    - Sara pays equal dividends to her spouse to support lifestyle.
    - Any excess earnings are saved inside her corporation.
- New Rules
    - Sara pays dividends to support lifestyle and save after-tax earnings inside her corporation until the corporate passive income reaches a level where the small business deduction is ground-down, then switch to salary.

    Service
    - Since her company is a professional/service corporation, she will not pay any dividends to her spouse until Sara is age 65.

Manufacturing

- If Sara had operated a manufacturing company instead, she would continue to be able to pay her spouse equal dividends because he owns at least 10% of the shares (votes and value) of the company

Annual Savings

The chart below compares what Sara will be able to save under 3 different scenarios.

Annual Savings from Ages 35 to 64

	Old Rules		New Rules - Manufacturing				New Rules - Service			
Age	Corp	Total	CPP	RRSP	Corp	Total	CPP	RRSP	Corp	Total
35	32,171	32,171			32,171	32,171			21,434	21,434
40	36,174	36,174			36,174	36,174			24,153	24,153
45	41,116	41,116			41,116	41,116			27,927	27,927
50	46,972	46,972			46,972	46,972			32,358	32,358
53	51,073	51,073			51,073	51,073			35,556	35,556
54	52,211	52,211			52,211	52,211			36,646	36,646
55	53,732	53,732			53,732	53,732			37,863	37,863
56	55,451	55,451			55,451	55,451			39,194	39,194
57	56,507	56,507			56,507	56,507			40,267	40,267
60	61,014	61,014			61,014	61,014			44,340	44,340
61	62,703	62,703			62,703	62,703			45,925	45,925
62	64,963	64,963			64,963	64,963			48,110	48,110
63	65,925	65,925			65,925	65,925			48,933	48,933
64	67,600	67,600			67,600	67,600			50,749	50,749
65						0				-
		1,429,270				1,429,270				1,000,927

Savings Assets

The chart below shows the balances of the various retirement savings vehicles throughout Sara's lifetime, under the 3 scenarios.

Savings Assets - $150,000 Income

Age	Self-Employed Business Owner		
	Old Rules	New Rules	
		Manufacturing	Service
35	32,171	32,171	21,434
40	218,809	218,809	141,135
45	483,422	483,422	310,209
50	854,868	854,868	550,355
55	1,370,564	1,370,564	887,608
60	2,075,900	2,075,900	1,355,751
65	2,827,721	2,827,721	1,813,106
70	2,851,328	2,851,328	1,524,840
75	2,785,283	2,785,283	1,053,991
80	2,600,766	2,600,766	336,336
85	2,252,988	2,252,988	
90	1,676,136	1,676,136	

Conclusion

- There is no difference in results between the old rules and a manufacturing company under the new rules because the business owner does not earn more than $50,000 of passive income inside her corporation. So she is not restricted on how much she can save inside her corporation.
- The big difference is if the company is a service/professional corp. The amount that can be saved is $400,000 less or a difference of 30%. This results in $1 million less savings assets at retirement and $1.6 million less at age 90. The business owner who is a service/professional corp actually runs out shortly after age 80.

Value of Paid Vacation/Stat/Sick and Professional development Days

The above analysis considered only a portion of the additional benefits an employer provides to an employee. This amounted to $27,564. See the chart below. Is there a cost to the business owner of being away from work due vacation, stat, sick and PD days?

Additional Benefits to Employee	Cost of Benefit
Employer Contributions to	
- Pension	$ 7,500
- CPP	$ 2,564
- Employee benefits, EI, training costs, dues etc	$ 5,000
	$15,064
Vacation, stat holidays, professional development and sick days	$23,080
Total Cost of Benefits	$38,144

We determined the cost of the vacation, stat holidays, PD and sick days as follows:

- Number of vacation days taken during year 20
- Number of statutory holidays during the year 11
- Number of PD days during year 5
- Number of sick days during year 4
- Total days where business owner is not working 40

- Total number of week days in year (5 x 52) 260
- Earnings per day worked ($150,000 / 260) $577/day
- Earnings reduction (40 days x $577/day) $23,080 / year

If the business owner is not working for 40 days during the year, the business owner does not earn income those days. Therefore the business owner's revised revenue is $126,920. What impact will this revised revenue have on the 3 scenarios for the business owner?

Annual Savings from Ages 35 to 64

Age	Old Rules		New Rules - Manufacturing				New Rules - Service			
	Corp	Total	CPP	RRSP	Corp	Total	CPP	RRSP	Corp	Total
35	11,976	11,976			11,976	11,976			1,239	1,239
40	13,285	13,285			13,285	13,285			1,368	1,368
45	15,128	15,128			15,128	15,128			1,510	1,510
50	17,232	17,232			17,232	17,232			1,668	1,668
53	18,705	18,705			18,705	18,705			1,770	1,770
54	19,288	19,288			19,288	19,288			1,806	1,806
55	19,837	19,837			19,837	19,837			1,842	1,842
56	20,344	20,344			20,344	20,344			1,878	1,878
57	20,967	20,967			20,967	20,967			1,916	1,916
60	22,827	22,827			22,827	22,827			2,033	2,033
61	23,519	23,519			23,519	23,519			2,074	2,074
62	24,228	24,228			24,228	24,228			2,116	2,116
63	24,891	24,891			24,891	24,891			2,157	2,157
64	25,670	25,670			25,670	25,670			2,201	2,201
65						0				-
		529,364				529,364				50,281

Savings Assets

Age	Self-Employed Business Owner		
	Old Rules	New Rules	
		Manufacturing	Service
35	11,976	11,976	1,239
40	76,110	76,110	7,820
45	161,534	161,534	15,083
50	281,339	281,339	23,102
55	447,635	447,635	31,958
60	675,973	675,973	41,733
65	820,944	820,944	1,326
70	212,294	212,294	
71	59,122	59,122	
72	1,054	1,054	
75			
80			
85			
90			

Conclusion

- By taking into account the full cost of the benefits received by employees from employers, the business owner's contributions are reduced by almost 63% under the old rules and for a manufacturing business under the new rules. For a service/professional corporation, the business owner's contributions are reduced by over 95%.

- The service business owner has 94% less savings at age 65 then the other two scenarios.
- If the business owner is living on a $85,000 lifestyle (indexed 2% per year), the business owner will run out of capital by age 72 under the old rules and for a manufacturing business under the new rules. For a service/professional corporation, the business owner will run out of capital by age 66.

How Does the Above Analysis Compare to the Employee's Situation

Annual Savings

The chart below shows what Brent will be able to contribute to the various savings vehicles and what his employer will be able to contribute to these savings vehicles for Brent.

Annual Savings from Ages 35 to 64 - Employee

Age	Employee Contributions					Employer Contributions			Total
	CPP	DC Pension	RRSP	TFSA	Total	CPP	DC Pension	Total	Contributions
35	2,564	7,500	11,530	2,599	24,193	2564	7,500	10,064	34,257
40	2,831	8,281	12,724	2,873	26,708	2831	8,281	11,112	37,820
45	3,126	9,142	14,048	3,172	29,488	3126	9,142	12,268	41,757
50	3,451	10,094	15,510	3,502	32,557	3451	10,094	13,545	46,102
55	3,810	11,145	17,124	3,867	35,945	3810	11,145	14,955	50,900
60	4,207	12,305	18,907	4,269	39,687	4207	12,305	16,512	56,199
64	4,553	13,319	20,465	4,621	42,958	4553	13,319	17,872	60,830
					981,355			408,279	1,389,634

Savings Assets

The chart below shows the balances of the various retirement savings vehicles throughout Brent's lifetime. Even though CPP is not liquid, the income stream from it is valued and shown as an asset.

Savings Assets - Employee

Age	Employee Savings Assets				
	CPP	DC Pension	RRSP	TFSA	Total
35	5,431	15,885	11,870	2,752	35,938
40	39,594	115,816	86,508	20,086	262,005
45	88,466	258,770	193,279	44,884	585,398
50	157,278	460,050	343,614	79,799	1,040,741
55	253,035	740,151	552,818	128,386	1,674,390
60	385,111	1,126,484	841,366	195,401	2,548,361
65	524,127	1,566,086	1,169,700	254,703	3,514,614
70	407,312	1,679,363	1,254,306	238,625	3,579,605
75	298,720	1,710,247	1,277,373	290,228	3,576,568
80	197,773	1,670,872	1,247,964	383,032	3,499,641
85	103,932	1,530,962	1,143,466	532,233	3,310,592
90	16,696	1,245,775	930,461	761,856	2,954,789

Comparison of Employee to Business owners 3 Scenarios

Savings Assets

Age	Employee	Self-Employed Business Owner		
		Old Rules	New Rules	
			Manufacturing	Service
35	35,938	32,171	32,171	21,434
40	262,005	218,809	218,809	141,135
45	585,398	483,422	483,422	310,209
50	1,040,741	854,868	854,868	550,355
55	1,674,390	1,370,564	1,370,564	887,608
60	2,548,361	2,075,900	2,075,900	1,355,751
65	3,514,614	2,827,721	2,827,721	1,813,106
70	3,579,605	2,851,328	2,851,328	1,524,840
75	3,576,568	2,785,283	2,785,283	1,053,991
80	3,499,641	2,600,766	2,600,766	336,336
85	3,310,592	2,252,988	2,252,988	
90	2,954,789	1,676,136	1,676,136	

Conclusion

- Under the old rules and new rules for a manufacturing business, the business owner has approximately 80% of the savings assets at age 65 of the employee. The service business owner has 48% less savings assets.
- The employee will still have almost $3 million in savings assets at age 90, while the business owner will have 43% less under the old rules and the new rules for a manufacturing business.

Clearly if the additional benefits an employee receives from an employer are taken into consideration, it is no contest. The employee wins by a landslide, even compared to the old rules where the federal government believed the business owner had an unfair advantage. These additional benefits cannot be ignored like the federal government chose to ignore them.

It is unimaginable that the federal government made the comparison between a business owner and employee to begin with. Trying to make them equal ignores the risks a business owner takes. It ignores the additional responsibilities a business owner takes on things like rent, overhead, wages, severance, worker’s compensation, equipment etc. If there is no reward to the business owner for these risks and responsibilities, why do it? The analysis shows there was no reward anyway under the old rules and now the federal government made it much worse? Why? Is that the federal government’s definition of making the tax system fair?