Business Owner Comparison to Employee - $300,000 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 $300,000 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 $300,000 before Sara pays herself any compensation. This is also indexed 2% until retirement. She has no pension plan or employee benefits at this time. $10,000 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 $140,000 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. Under the Old Rules, all her savings is inside the corporation. Under the New Rules, once the passive income earned on investments inside her company reaches a level where her ability to claim the $500,000 small business deduction is being impacted, she will start paying herself a salary. Therefore she will start contributing to CPP and RRSP.

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	85,492	85,492			85,492	85,492			57,751	57,751
40	96,794	96,794			96,794	96,794			66,012	66,012
45	110,473	110,473			110,473	110,473			78,551	78,551
50	126,310	126,310			126,310	126,310			93,550	93,550
53	137,022	137,022	7,324		125,972	133,296			103,892	103,892
54	140,855	140,855	7,470	18,000	113,398	138,868			107,663	107,663
55	144,828	144,828	7,620	18,000	117,596	143,216			111,610	111,610
56	148,948	148,948	7,772	18,000	121,453	147,225	7772		101,804	109,576
57	153,222	153,222	7,928	24,300	118,116	150,344	7928	18,000	91,114	117,042
60	167,043	167,043	8,414	29,700	103,564	141,678	8414	22,500	97,774	128,688
61	172,009	172,009	8,582	29,700	100,580	138,862	8582	31,500	93,075	133,157
62	177,168	177,168	8,754	30,600	96,052	135,406	8754	40,500	88,507	137,761
63	182,532	182,532	8,928	30,600	92,101	131,629	8928	45,667	87,182	141,777
64	188,102	188,102	9,106	30,600	88,613	128,319	9106	46,580	85,721	141,407
65				30,600		30,600		47,512		47,512
		3,861,752				3,642,634				2,892,717

Savings Assets

The chart below shows the balances of the various retirement savings vehicles throughout Sara's lifetime, under the 3 scenarios. Even though CPP is not liquid, the income stream from it is valued and shown as an asset.

Savings Assets

Age	Old Rules		New Rules - Manufacturing				New Rules - Service			
	Corp	Total	CPP	RRSP	Corp	Total	CPP	RRSP	Corp	Total
35	84,987	84,987			84,987	84,987			57,163	57,163
40	616,609	616,609			616,609	616,609			413,215	413,215
45	1,376,469	1,376,469			1,376,469	1,376,469			937,482	937,482
50	2,439,884	2,439,884			2,439,884	2,439,884			1,691,895	1,691,895
55	3,908,784	3,908,784	25,145	39,249	3,842,666	3,907,060			2,757,360	2,757,360
60	5,919,186	5,919,186	81,578	206,847	5,524,173	5,812,598	48,087	88,031	4,187,580	4,323,698
65	8,176,900	8,176,900	158,286	456,614	7,132,139	7,747,039	121,352	366,934	5,670,775	6,159,061
70	8,950,675	8,950,675	123,047	608,175	7,674,439	8,405,661	94,336	488,729	5,922,706	6,505,771
75	9,725,770	9,725,770	90,242	651,003	8,283,788	9,025,033	69,186	526,522	6,052,334	6,648,042
80	10,506,129	10,506,129	59,746	636,016	8,920,219	9,615,981	45,805	519,130	6,047,106	6,612,041
85	11,292,422	11,292,422	31,397	582,759	9,562,386	10,176,542	24,071	480,979	5,815,504	6,320,554
90	12,080,261	12,080,261	5,044	474,203	10,204,606	10,683,853	3,867	397,228	5,262,854	5,663,949

Conclusion

- Not a big difference in results between the old rules and a manufacturing company under the new rules. The difference is a result of the passive income rules limiting the amount that is being saved in the corporation under the new rules.
- The big difference is if the company is a service/professional corp. The amount that can be saved is $1 million less or 25%. This results in $2 million less savings assets at retirement and $6.4 million less at age 90. That is a 53% reduction.

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	$15,000
- CPP	$ 2,564
- Employee benefits, EI, training costs, dues etc	$10,000
	$27,564
Vacation, stat holidays, professional development and sick days	$46,160
Total Cost of Benefits	$73,724

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 ($300,000 / 260) — $1,154/day
- Earnings reduction (40 days x $1,154/day) — $46,160 / 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 $253,840. What impact will this revised revenue have on the 3 scenarios for the business owner?

Annual Savings from Ages 35 to 64

	Old Rules		New Rules - Manufacturing				New Rules - Service	
Age	Corp	Total	CPP	RRSP	Corp	Total	Corp	Total
35	44,107	44,107			44,107	44,107	15,121	15,121
40	50,777	50,777			50,777	50,777	18,841	18,841
45	58,684	58,684			58,684	58,684	22,159	22,159
50	67,319	67,319			67,319	67,319	27,028	27,028
55	77,623	77,623			77,623	77,623	33,234	33,234
60	89,670	89,670			89,670	89,670	41,157	41,157
61	92,346	92,346	8,582		78,406	86,988	42,994	42,994
62	95,125	95,125	8,754	27,000	58,429	94,183	44,926	44,926
63	98,012	98,012	8,928	27,000	61,229	97,157	46,852	46,852
64	101,013	101,013	9,106	27,000	64,100	100,206	48,786	48,786
65				27,000		27,000		-
		2,055,924				2,074,962		851,560

Savings Assets

Age	Old Rules		New Rules - Manufacturing				New Rules - Service	
	Corp	Total	CPP	RRSP	Corp	Total	Corp	Total
35	46,321	46,321			44,602	44,602	15,877	15,877
40	322,077	322,077			322,077	322,077	113,742	113,742
45	721,046	721,046			721,046	721,046	258,954	258,954
50	1,281,654	1,281,654			1,281,654	1,281,654	470,345	470,345
55	2,057,779	2,057,779			2,057,779	2,057,779	773,478	773,478
60	3,121,682	3,121,682			3,121,682	3,121,682	1,203,453	1,203,453
61	3,376,840	3,376,840	9,088		3,364,410	3,373,498	1,308,621	1,308,621
62	3,648,110	3,648,110	18,895	28,593	3,599,379	3,646,867	1,421,187	1,421,187
63	3,936,444	3,936,444	29,465	58,873	3,849,273	3,937,611	1,541,530	1,541,530
64	4,242,847	4,242,847	40,846	90,939	4,114,966	4,246,751	1,670,066	1,670,066
65	4,203,357	4,203,357	52,762	124,897	4,047,478	4,225,137	1,479,679	1,479,679
70	3,894,868	3,894,868	41,016	166,352	3,703,129	3,910,497	279,863	279,863
75	3,323,669	3,323,669	30,081		3,269,535	3,299,616		0
80	2,382,920	2,382,920	19,915		2,326,779	2,346,694		0
85	923,951	923,951	10,466		865,679	876,145		0
86	552,215	552,215	8,657		493,575	502,232		0
87	149,972	149,972	6,875		91,091	97,966		0
88	2,632	2,632	5,118		1,918	7,036		0
89		0	3,387			3,387		0
90		0	1,681			1,681		0

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 47% 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 70%.
- The service business owner has 65% less savings at age 65 then the other two scenarios.
- If the business owner is living on a $140,000 lifestyle (indexed 2% per year), the business owner will run out of capital by age 88 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 72.

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 Contributions
	CPP	DC Pension	TFSA	Non-Reg	Total	CPP	DC Pension	Non-Reg	Total	
35	2,564	14,798	11,000	11,317	39,679	2564	11,957	2,940	17,461	57,140
40	2,831	16,338	12,000	12,498	43,667	2831	13,201	3,246	19,278	62,945
45	3,126	18,039	13,000	13,825	47,990	3126	14,575	3,584	21,285	69,275
50	3,451	19,916	14,000	15,309	52,676	3451	16,092	3,957	23,500	76,176
55	3,810	21,989	15,000	16,954	57,753	3810	17,767	4,369	25,946	83,699
60	4,207	24,278	16,000	18,757	63,242	4207	19,616	4,823	28,646	91,888
64	4,553	26,279	17,000	20,662	68,494	4553	21,233	5,221	31,007	99,501
					1,563,860				**708,351**	**2,272,211**

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	TFSA	Non-Reg	Total
35	5,431	27,418	11,273	14,547	58,669
40	39,594	199,900	82,908	102,340	424,742
45	88,466	446,638	182,870	223,428	941,402
50	157,278	794,049	321,777	385,888	1,658,992
55	253,035	1,277,504	512,556	601,140	2,644,235
60	385,111	1,944,316	772,424	883,548	3,985,399
65	524,127	2,808,064	1,125,532	1,005,039	5,462,762
70	407,312	3,740,131	1,582,634		5,730,077
75	298,720	3,753,196	1,608,023		5,659,939
80	197,773	3,697,548	1,553,927		5,449,248
85	103,932	3,425,816	1,460,341		4,990,089
90	16,696	2,829,288	1,322,585		4,168,569

Comparison of Employee to Business owners 3 Scenarios

Savings Assets

Age	Employee	Self-Employed Business Owner		
		Old Rules	New Rules	
			Manufacturing	Service
35	58,669	46,321	44,602	15,877
40	424,742	322,077	322,077	113,742
45	941,402	721,046	721,046	258,954
50	1,658,992	1,281,654	1,281,654	470,345
55	2,644,235	2,057,779	2,057,779	773,478
60	3,985,399	3,121,682	3,121,682	1,203,453
65	5,462,762	4,203,357	4,225,137	1,479,679
70	5,730,077	3,894,868	3,910,497	279,863
75	5,659,939	3,323,669	3,299,616	0
80	5,449,248	2,382,920	2,346,694	0
85	4,990,089	923,951	876,145	0
90	4,168,569	0	0	0

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 73% less savings assets.
- The employee will still have over $4 million in savings assets at age 90, while the business owner will have nothing in all three scenarios.

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?