APCC Association of Professional Computer Consultants

Theory of Integration

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Introduction

The Income Tax Act provides for an equality of **Tax Rate** on:

- Income **paid out as salary** as opposed to
- Income when it is **paid into a corporation**:
    - Where it is first subject to corporate tax and
    - Then distributed by way of dividend to a share holder where it is then subject to dividend tax.

This concept of equality is sometimes referred to as the Theory of Integration, with the white paper provided along with this summary providing detail as to how this equality is achieved.

In his Oct 6, 2010 response to the Standing Committee on Finance, The Minister of Finance presented what some people view as an unfair comparison of Small Business Corporate Tax rates in each Quebec and Manitoba to the federal/provincial income tax rate. In fairness, the Minister's suggestion that they were unequal was not an accurate statement. In reality the Minister's comparison of **Income Tax Rate** to a **Small Business Corporate Tax Rate** was a comparison of apples to oranges.

What the Minister appears to have overlooked was that the corporate tax rate is applied to net income (i.e. the company's Gross Revenues less salaries and other business expenses) after which the remaining (i.e. after tax) amount is termed "Retained Earnings" and these funds retained in the corporation for the **exclusive use of the corporation**. Should those funds be required outside of the corporation for personal use (as is the case of income net of income tax), then those funds need to be distributed by Dividend at which time they will be subject to Dividend Tax.

The Theory of Integration articulated the Income Tax reality that regardless of the way that funds are distributed the effective tax rates are the same or similar and as such there is no preferential tax rate treatment.

Ironically the suggestion that a contractor receives some form of preferential tax rate and further that the government is receiving less tax dollars represents a misunderstanding of the facts.

An employee receives benefits in addition to salary. A number of these benefits come in the form of employer contributions to benefit programs which will pay out income to the employee sometime in the future (i.e. terminating pay, pensions, long term disability, etc). A contractor is paid a dollar rate but does not receive any benefits. Functionally the premium paid to the contractor is a monetization of the benefits paid to the FTE plus the possibility of an additional premium for work continuity risk.

The attached graphic shows the flow of income to an employee for distribution as salary in comparison to the funds that contractor would receive for comparable services. In this graphic it is suggested that the premium paid to the contractor would be 50% above the FTE's salary.

As the contractor flow suggests there are multiple places for the government to realize additional tax rate;

1. The contractor's invoice for services as presented to the client corporation is subject to sales tax (GST / HST / QST). An employee's salary is not subject to sales tax;
2. The diagram suggests that the contractor needs just as much income to live on as the FTE so the same salary amount is taken out with the contractor paying the same income tax rate and consequential the same income tax amount;
3. The corporate tax rate applied against the net profits generates tax for the government;
4. When Retained Earnings are distributed as dividends they are then subject to Dividend tax thereby generating more tax revenue for the government.

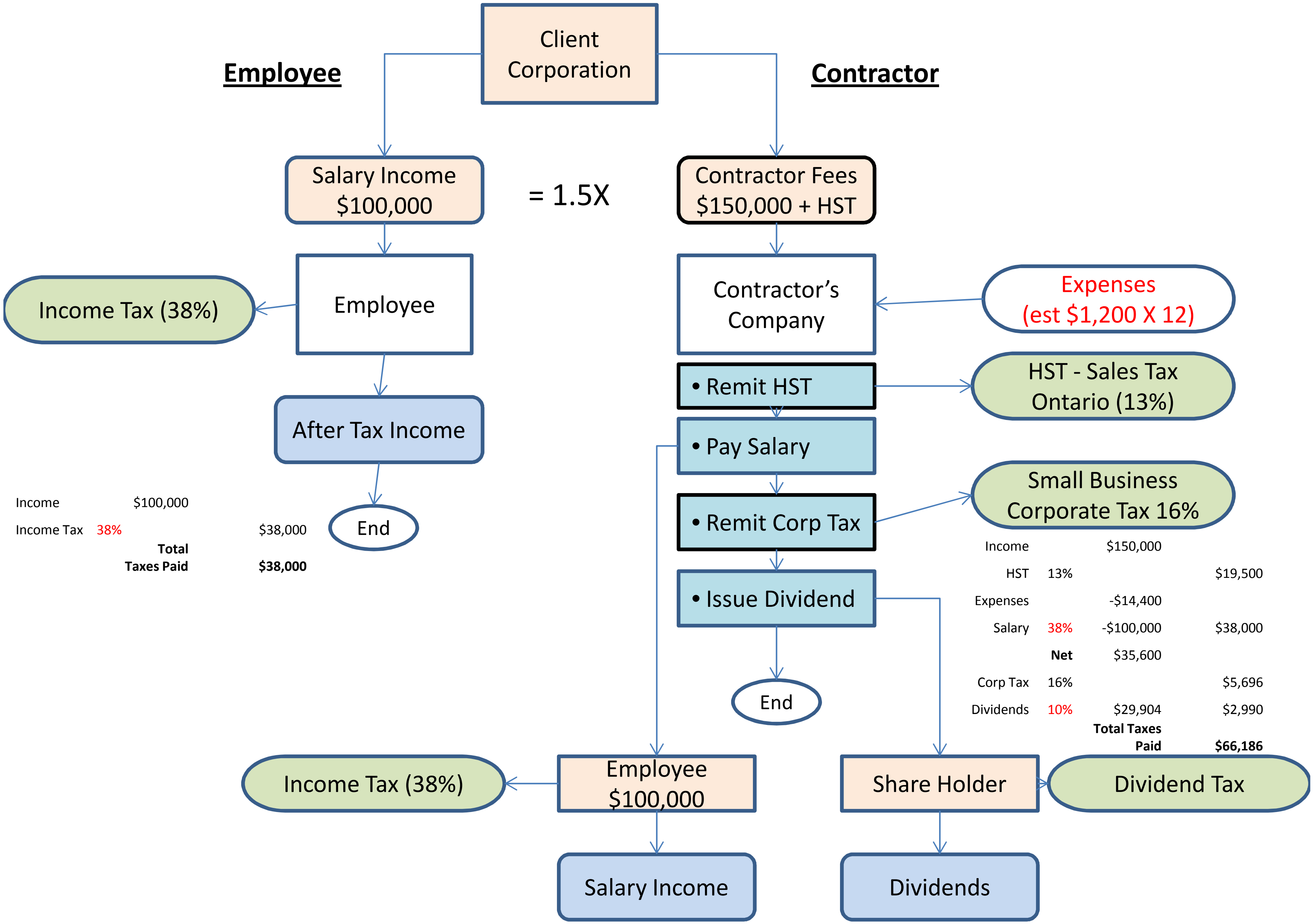
In summary, contractors not only do not receive a preferential tax rate; they also provide a greater source of tax revenue for the government. Contractors pay the same or similar tax rate on funds they take out of their company for personal use. They also pay sales tax on whatever their company earns and they pay corporate tax.

When the government introduced its punitive measures for service delivery corporations which they term PSB's it indentified a number of objectives including:

1. To put an end to what they described a preferential tax treatment and
2. To increase tax revenues and
3. To tax revenues in the year that the income is received.

Ironically their measures appear to have unintended consequences as follows:

1. If a contractor returns to full time employment, his/her taxable income will be reduced since employee benefits will no longer be monetized and taxable in a contractor's rate;
2. Contributions to the FTE's benefits programs will be tax deductible by the employer and the government will not be able to tax the proceeds from those programs until sometime in the future when they are paid out; and
3. Sales tax on the contractor's income will no longer be applicable because an employee's salary income is not subject to sales tax.


Employee
Contractor
Client Corporation
Salary Income $100,000
= 1.5X
Contractor Fees $150,000 + HST
Income Tax (38%)
Employee
Contractor's Company
Expenses (est $1,200 X 12)
After Tax Income
• Remit HST
HST - Sales Tax Ontario (13%)
• Pay Salary
Small Business Corporate Tax 16%
• Remit Corp Tax
• Issue Dividend
End
Income $100,000
Income Tax 38% $38,000
Total Taxes Paid $38,000
Income $150,000
HST 13% $19,500
Expenses -$14,400
Salary 38% -$100,000 $38,000
Net $35,600
Corp Tax 16% $5,696
Dividends 10% $29,904 $2,990
Total Taxes Paid $66,186
End
Income Tax (38%)
Employee $100,000
Share Holder
Dividend Tax
Salary Income
Dividends

Government Response to the Standing Committee on Finance "Servant Or Master? Differing Interpretations of a Personal Services Business"

In June 2010, the Standing Committee on Finance tabled the report titled "Servant or Master? Differing Interpretations of a Personal Services Business". The report recommended that the Government review the *Income Tax Act* to ensure tax fairness for small business owners, particularly those in the information technology (IT) sector, who are determined to be "incorporated employees" of "personal services businesses".

The Government recognizes the importance of small businesses to the Canadian economy and is committed to ensuring tax fairness for all Canadians.

The personal services business provisions in the *Income Tax Act* apply to all industries to ensure that individuals, who would otherwise be employees, are unable to avoid paying their fair share of tax by interposing a corporation between themselves and a service recipient that would otherwise be the individual's employer. The personal services business provisions are intended to ensure that "incorporated employees" are treated comparably to actual employees for income tax purposes.

Given the varying circumstances in which income may be earned, the *Income Tax Act* has specific rules to ensure that different types of income are treated fairly.

Business income is generated by an entrepreneurial venture in which investments are made (e.g., capital assets are purchased, workers are hired and trained) with a view to earning revenue by bringing goods or services to the market. An entrepreneur undertakes risks as part of an independent venture seeking to earn a profit in unpredictable market conditions that may affect the venture's performance and even lead to losses. The income tax system recognizes the risk inherent in business enterprises by taxing the resulting profits appropriately, which means allowing for the deduction of reasonable expenses incurred in generating those profits.

In the case of certain small business income, the small business deduction provides a reduced rate of income tax on the first $500,000 of qualifying business income earned in a year by an eligible Canadian-controlled private corporation. The federal small business income tax rate for 2010 is 11%. This lower rate helps these small businesses retain more of their earnings for reinvestment and expansion, thereby helping to create jobs and promote economic growth.

In contrast, employment income is subject to a progressive income tax rate structure with rates increasing as income increases. Employment expenses incurred by employees are generally not deductible for income tax purposes since employers typically provide employees with the items required to perform their duties or reimburse their employees for the work-related expenses they incur. To recognise that employees incur some costs personally, employees are eligible for the Canada Employment Credit, introduced in Budget 2006, which provides a 15% tax credit in respect of up to $1,000 of employment income.

Corporations that operate a "personal services business" do not qualify for the small business deduction and are not eligible for the 11% federal small business income tax rate. The objective of the personal services business provisions in the*Income Tax Act* is to ensure that individuals ("incorporated employees") who would otherwise be in an employment relationship, if they had not interposed a corporation between themselves and the service recipient, are treated comparably for income tax purposes as if they had provided their employment services directly (in other words, as if they had not interposed the corporation). Without the personal services business provisions, incorporated employees could reduce their income tax liability unfairly.

The small business deduction was not intended to be available to individuals who have essentially converted an employment relationship into a business relationship through the interposition of a personal services business corporation.

Whether an individual would be an employee (employment relationship) or an independent contractor (business relationship), if the corporation had not been interposed, is determined on a case-by-case basis. In making this determination, the Canada Revenue Agency takes into account a number of factors, for example: the extent of the service recipient's control over the individual concerning the manner in which the services are performed and what services are performed; the amount of risk the individual has of bearing an economic loss; and the individual's responsibility for providing the tools required to perform the services for the service recipient. The Canada Revenue Agency's determination, of whether an individual is an employee or an independent contractor, may be appealed to the Tax Court of Canada.

Amending the personal services business provisions to exclude corporations of information technology (IT) professionals would result in such professionals receiving preferential treatment compared to employees who are not incorporated, for that portion of their remuneration that is taxed inside the corporation. For example,

- in Quebec, the province of residence of many of the individuals who made presentations to the Committee, it could result in the income of a corporation of an incorporated employee earning $150,000 in 2010 being taxed at a combined federal and provincial small business income tax rate of 19% (11% federal plus 8% provincial) while an unincorporated employee carrying out similar work for the same company and earning the same amount would be taxed at an average federal/provincial personal income tax rate of 37%.

- in Manitoba, where the small business tax rate is 0% in 2011, it could result in the income of a corporation of an incorporated employee earning $150,000 in 2011 being taxed at a combined federal and provincial small business income tax rate of 11% while an unincorporated employee carrying out similar work for the same company and earning the same amount would be taxed at an average federal/provincial personal income tax rate of 35%.

The Standing Committee's Report also expressed concern that individuals who provide services through a personal services business corporation ("incorporated employees") are not eligible to participate in the Canada Pension Plan (CPP) and the Employment Insurance (EI) regimes.

The provisions in the *Income Tax Act* that apply to incorporated employees do not prevent them from participating in the CPP and EI regimes.

Individuals are required to participate in the CPP regime if they receive a salary. The income tax provisions concerning personal services businesses would, therefore, not prevent an incorporated employee from participating in the CPP regime where the incorporated employee receives a salary from the personal services business corporation.

The Government recognizes that some incorporated employees have not been eligible to participate in the Employment Insurance regime because the individual controls more than 40% of the voting shares of the corporation. However, since the Committee met on December 3, 2009, the *Fairness for the Self-Employed Act* received Royal Assent. As a result, the Employment Insurance special benefits provisions have been extended, on a voluntary opt-in basis, to the self-employed and to employees whose employment by a corporation was previously excluded from insurable employment because the individual controls more than 40% of the voting shares of the corporation. Employment Insurance special benefits include maternity benefits, parental benefits, sickness benefits, and compassionate care benefits.

The Government recognizes the importance of the IT sector in fostering innovation and creating jobs and business opportunities. The Business Development Bank of Canada provides financial support for business innovation, often to small firms involved in the IT sector. Small and medium-sized firms in the IT sector also benefit from the improvements to the Scientific Research and Experimental Development Tax Incentive Program that were introduced in Budget 2008. Canada’s Economic Action Plan, announced in 2009, also included a number of initiatives that assist firms in the IT sector, including small businesses. For example, businesses may benefit from the temporary two-year 100-per-cent capital cost allowance rate for computers. As well, additional funding was provided to the National Research Council’s Industrial Research Assistance Program to enable it to temporarily expand its initiatives for small and medium-sized firms and to Industry Canada to develop and implement a strategy to extend broadband coverage. Further, the Government has indicated it would develop a Digital Economy Strategy to position Canada’s information and communications technology sector to establish a global advantage.

Integration of Corporate and Personal Income taxes

As an accountant one of the areas that I have found to cause stress amongst my "Canadian controlled private corporation" ("CCPC") clients is "how should I remunerate myself" to achieve tax efficiency. They like hearing that the corporate rate is 15.5%, (Ontario combined Federal and Provincial rates for active taxable income less than $500K) but are often dismayed to find out that when funds are distributed by way of dividends a personal tax cost is incurred. They often question, "am I not paying overall more tax by paying the corporate tax then taking the balance out by a dividend"? The simplistic answer is no. That is, most business owners should be indifferent in choosing between salary and dividends from an overall tax perspective. However, for those with a desire to take advantage of Registered Retirement Savings Plan ("RRSP") contributions, salary remuneration is required.

The Canadian tax system is designed so an individual should be indifferent between earning income though a Canadian corporation by salary or dividend.

To avoid an increased overall tax burden or "double taxation" on the income earned by a corporation there is a gross-up and dividend tax credit mechanism (issued by T5 slips). This system provides recognition for the corporate taxes already paid, to the taxable residents in Canada who receive these dividends. Dividends on T5 slips are classified as "eligible" or "non eligible":

- Non-eligible dividends have a "gross-up" of the actual dividend figure and a tax credit to reflect the corporate tax paid that was eligible for the small business tax rate.
- Eligible dividends have a "gross-up" of the actual dividend figure and a tax credit to reflect the corporate tax paid for CCPC's not eligible for the small business tax rate or other Canadian corporations that pay tax at the higher corporate rates.

"Flowing-out" income from a company by way of "salary versus dividends", theoretically a business owner should be indifferent. The following 2 charts analyze this concept.

I. "Flow-out" of Company income subject to the Small Business tax rate (Chart I).

	Flow-out by	
	Salary	Dividends
Company:		
Company earns, taxable income	$ 1,000	$ 1,000
Salary	(1,000)	-
Taxable income	-	1,000
*Taxes – 15.5%	-	155
Funds in Company	$ -	$ 845
*Personal taxes		
Salary	$ 1,000	$ -
Dividend – "ineligible"	-	845
*Taxes (46.41% (S) – 32.57% (D))	(464)	(275)
Funds after distribution	$ 536	$ 570
Taxes:		
Company	$ -	$ 155
Personal	464	275
	$ 464	$ 430

*Assuming highest marginal tax rate for resident of Ontario, (but not $500K personal threshold additional Ontario tax) and Ontario corporate rates.

Conclusion

In Ontario (and most other provinces to varying degrees) there is a tax savings of $34 ($464-$430) on every $1,000 the Company earns by paying out dividends versus salary, or 3.4%.

II. "Flow-out" of Company income not subject to the Small Business tax rate (Chart II).

	Flow-out by	
	Salary	Dividends
Company:		
Company earns, taxable income	$ 1,000	$ 1,000
Salary	(1,000)	-
Taxable income	-	1,000
*Taxes – 26.5%	-	265
Funds in Company	$ -	$ 735
*Personal taxes		
Salary	$ 1,000	$ -
Dividend – "eligible"	-	735
*Taxes (46.41% (S) – 29.54% (D))	(464)	(217)
Funds after distribution	$ 536	$ 518
Taxes:		
Company	$ -	$ 265
Personal	464	217
	$ 464	$ 482

*Assuming highest marginal tax rate for resident of Ontario, (but not $500K personal threshold additional Ontario tax) and Ontario corporate rates.

Conclusion

In Ontario (and most other provinces to varying degrees) there is a tax cost of $18 ($464-$482) on every $1,000 the Company earns by paying out dividends versus salary, or 1.8%.

The Tax Deferral Opportunity of Maintaining Funds in the Company

My experience is that a high percentage of clients, in the service industry, distribute to themselves most of what the Company earns on an annual basis. However, there is a significant tax deferral advantage if funds can be maintained in the corporation. With the deferral, there is then a greater level of funds to invest, versus taking the funds "out", paying the personal tax then investing.

Going back to Chart I, it can be seen that if funds are maintained in the corporation there is $845 available for investment versus either $536 or $570 if funds are distributed to the individual. The compounding benefit of investing these "tax deferred" funds, similar to RRSP funds, can be significant.

Going back to Chart II, it can be seen that if funds are maintained in the corporation there is $735 available for investment versus either $536 or $518. The compounding benefit of investing these funds should, of course subject to investment returns, offset the slight (1.8%) disadvantage of ultimately distributing the funds by a dividend, in a relatively short time.

The change in rules by CRA with respect to the classification of dividends as "eligible" or "non-eligible" was in response to Canadian corporations converting to income trust structures. Corporations were converting to income trusts, to eliminate the existing, at the time, "double taxation". This resulted when corporations paying the high corporate tax rate distributed, by dividends, their after tax income. Though there was still a tax deferral on paying the corporate tax and leaving funds in the corporation, the number of years of "investment gain" to offset this figure was significant, of course subject to investment returns. Therefore, "bonusing" down to the small business tax rate limit (was $200K raised to present $500K figure) was generally the preferred tax plan, for CCPCs. Based on the above analysis, unless funds are fully distributed in the current year, bonusing down to the small business tax limit is no longer the preferred plan.

Other issues

- **No RRSP contribution room if remuneration by way of dividends**

Dividends are not considered "earned income" so this form of remuneration does not earn "room" that allows for RRSP contributions. The question "is it better to take remuneration by salary, pay greater personal tax, but then contribute to a RRSP"? This analysis is complicated. However, the tax deferred and actual tax benefits by maintaining funds in the corporation, taxed at the small business rates, can potentially outweigh the tax-free investment returns made within a RRSP. However, to "focus" investment strategy, annual contributions to a RRSP seems preferred. Therefore, receiving a salary at a level to maximize the RRSP contribution room figure seems to make sense, or up to approximately $128,000 with the balance of remuneration as dividends (for small business taxed income).

Conclusion:

Though dividend remuneration provides a small overall tax benefit by "flowing out" funds earned in this manner, this benefit is "negated" by the fact RRSP contribution room is not earned. Thus the tax benefit of RRSP deductions is lost if remuneration by dividends.

- **Asset protection and potential loss of the $750K lifetime capital gains exemption ("LCG")**

The LCG is available for disposition of qualified small business corporation shares. To be eligible certain asset tests must be achieved. If significant investments not active to the business are built-up, then on the sale of the shares the shareholder may not have access to the LCG.

In any case, for "asset protection", to ensure investments are not exposed to liabilities of the corporation through its active businesses, it is generally desirable to hold investments in a "holding" company concept.

The above discussion applies to companies of all sizes.

A significant issue that affects smaller consulting companies, may change much of the tax planning discussion above. In October 2011 the Federal Government proposed amendments to the Income Tax Act which would apply to companies deemed to be a Personal Service Business. These proposed changes would apply to situations where the government was trying to "deal with situations where a corporation has been interposed between a service recipient and an individual that has been otherwise constituted an employer-employee relationship".

In such instances, the government's goal was to disallow all expenses which were not available to an employee and eliminate or make unreasonable the option of deferring the taxation of income as dividends, effectively requiring the contractor to declare all income in the year that it was earned.

However, that is a discussion for another day.

Of course no plan should be implemented without proper professional advice.

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