December 16, 2013

Key Takeaways for McDowall Associates Clients:

1. Canadian executives get little or no credit for the amount of income taxes they pay.

2. Canadian executives pay twice as much tax on every dollar of their income than typical wage earners pay per dollar on their income.

3. The "CEO Tax Ratio" can be twice as much as the "CEO Pay Ratio".

The CEO Pay Paradox: Do Canadian Executives Pay Their Fair Share in Income Tax?

Executive Summary

Canadian executives face a paradox: their compensation is heavily scrutinized by key stakeholders, and often vilified by the media; yet they get little or no credit for the contribution they personally make to Canada's economy, especially for the high level of income taxes they currently pay.

Is the compensation of Canada's executives too high? Many think the answer is "yes", and that companies should therefore be required to place limits on their "CEO Pay Ratios"[1] as we discussed in our September 23, 2013 article.[2]

Do Canadian executives pay their fair share in taxes? We believe the answer is a resounding "yes" based on our research. High income earners pay a lot of tax - in fact about twice as much for every dollar of their pre-tax income as the tax payable per dollar of income by a typical wage earner. What we at McDowall Associates are calling the "CEO Tax Ratio" can be twice that of the "CEO Pay Ratio".

[1] The intention of the "CEO Pay Ratio" is to compare the CEO's compensation with that of a company's typical employee. It is usually expressed in the form of a multiple e.g. 133 to 1
[2] http://www.mcdowallassociates.com/wp-content/uploads/Statistics-Canada-Release-Report-on-Canadian-Income-Earnings-Newsletter.pdf

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Key Takeaways for McDowall Associates Clients:

4. Swiss voters turned down a proposal to limit a CEO's compensation to 12 times the company's lowest paid worker, in part because they were advised by their government that it would be counterproductive.

5. We estimated the amount of income taxes payable on the total direct compensation reported for the 60 CEOs in the S&P/TSX 60 Index.

6. These results were then compared to the income taxes payable by an individual earning the Average Industrial Wage using the same assumptions.

Background

The increasing focus on the amount of income that executives earn relative to that of the typical employee, as represented by the "CEO Pay Ratio", does not take into account the amount of income tax that these very executives pay. Interestingly, during a recent referendum the Switzerland government chose not to support a proposal to limit the pay of a company's CEO to 12 times that of the company's lowest paid worker, warning that it would lead to very significant total revenue shortfalls for the country. While a solid 65.3% of the Swiss voters turned down the proposal, one can't help but wonder what will come next.

In making our case for Canada's executives in this article, we first delve into the compensation of Chief Executive Officers (CEOs) from our executive compensation database at McDowall Associates. We then compare our findings with the most recently available information on the income taxes paid by Canadian high income earners from Statistics Canada's (StatsCan) CANSIM databank.

Methodology

Our approach to the CEO tax payer analysis is as follows:

- Take the earnings of the 60 CEOs of the publicly traded companies in the S&P/TSX 60 Index as reported to shareholders in their management proxy circulars;
- Estimate the income taxes the CEOs might have to pay on their reported earnings as if the hypothetical value of all the long term incentive awards for the year were actually paid out at the time they were granted (not when they vest); and then
- Compare the CEO tax estimates to the income taxes payable by a group of full time employees, as represented by Canada's average industrial wage (AIW).

The most recently available StatsCan personal income tax analysis is for the 2010 tax year. In order to be able to compare our CEO results with the StatsCan data, we focus on the average 2010 S&P/TSX 60 CEO total direct compensation data from our database.[3] To simplify our tax estimates, we then apply the 2010 Federal and Ontario tax rates for a single taxpayer to this income with no offsetting tax deductions (such as registered pension plan contributions) and limit the refundable tax credits to the basic exemption and the Canada Pension Plan and Employment Insurance contribution exemptions. The same tax calculation approach is applied to our Average Industrial Wage earner tax estimates.

[3] Interestingly, the CEO average and the CEO median total direct compensation for 2010 were similar, which is not typical in our experience.

Key Takeaways for McDowall Associates Clients:

7. The CEO Tax Ratio is much more significant than the CEO Pay Ratio is.

8. The amount of income tax payable by the 60 CEOs in the S&P/TSX 60 Index corresponds to that of a town with a population of almost 20,000 fulltime workers.

9. Statistics Canada has an extensive personal income tax data base that we carefully examined.

The pre-tax income comparisons are shown in Table 1 below:

Table 1

	S&P/TSX 60 CEOs	2010 Average Industrial Wage	CEO Pay Ratio
2010 Average Total Direct Compensation[4 5]	$6,208,000	$46,600	133 to 1

The estimated income taxes in 2010 for the two groups is summarized in Table 2 below:

Table 2

	S&P/TSX 60 CEOs	2010 Average Industrial Wage	CEO Tax Ratio
2010 Average Income Tax (McDowall Estimates)	$2,522,000 [6] (40.6%)	$7,993 (17.1%)	316 to 1

Table 2 illustrates that the average S&P/TSX 60 CEO would have had to pay the same amount of income tax on his or her 2010 total direct compensation awards as 316 other individual Canadians earning the Average Industrial Wage in 2010.[7]

There are several other ways of looking at these findings. For example, the CEO Tax Ratio of 316 in Table 2 represents 238% of the CEO Pay Ratio of 133 in Table 1. In addition, some 19,000 AIW level employees would be needed to come up with our total tax projections of about $150 million for all 60 S&P/TSX 60 CEOs.

StatsCan Personal Income Tax Database

To support our large company CEO Tax Ratio conclusions, we consider the most recently available information on the personal taxes paid by high income earners contained in Statistics Canada (StatsCan)'s CANSIM data base.

StatsCan has access at a macro level to the personal income tax returns filed with the Canada Revenue Agency each year. The most recently released study as of the date of this article covers the period from 1982 to 2010.[8] While the study slices and dices the database in numerous ways,

[4] "Total direct compensation" is a common compensation term that includes annual base salary, annual incentive awards and the present value of long-term incentives awarded in the year, such as restricted stock units, performance stock units and stock options, as reported to shareholders in the Summary Compensation Table of the management proxy circular.
[5] We assume that the AIW earner's compensation is all paid in current cash.
[6] Assumes 50% of the grant date value of CEO stock options will be taxable on exercise.
[7] Assuming the CEO's long-term incentive awards for the year will actually pay out at the values reported to the shareholders in the Summary Compensation Table.
[8] CANSIM 2004-0001 2010. The complete 28.3 MB file can be downloaded from StatsCan's website at http://www5.statcan.gc.ca/cansim/a26?

Key Takeaways for McDowall Associates Clients:

10. We looked for a group of taxpayers whose average income was similar to that of the 60 CEOs in the S&P/TSX 60 Index.

11. We also looked for a group of taxpayers whose average income before government transfers was similar to the Average Industrial Wage.

there are some limitations for compensation purposes, as most of the StatsCan income analysis lumps employment income together with self-employment income, rental income, dividends, interest, capital gains, company pension benefits and RRSP/RRIP income.

The closest match to the 2010 AIW of $46,629[9] we find in the StatsCan personal income tax database is a group of 10.2 million tax filers whose 2010 "market income"[10] including capital gains (but excluding government transfers) ranged from $22,600 to $80,600. With an average income in 2010 of $45,200, this group represents the 50th to the 90th percentile pre-tax income earners out of a total of 25.5 million tax filers in 2010.[11]

Meanwhile, the closest match we find to a 2010 S&P/TSX 60 CEO with total direct compensation of around $6.0 million is StatsCan's "Top 0.01 percent income group". This is a very small group of 2,550 tax filers whose median 2010 "market income" including capital gains was $4,625,900. The average income of this group was $6,057,100, of which 54.7% or $3,313,200 came from wages and salaries and approximately 15% or $945,000 from capital gains.

The pre-tax income ratios for these two groups are shown in Table 3 below.

Table 3

	Top 0.01 Percent Tax Filer Group	50th to 90th Percentile Tax Filer Group	High Income Earner Pre-Tax Ratio
Number of tax filers	2,550	10.2 million	
Pre-tax Income range	$3,155,800 and over	$22,600 to $82,600	
Average income	$6,057,100	$45,200	134 to 1
Total income for the group	$15.4 billion	$460.5 billion	1 to 29.9

[9] Average of the monthly AIW throughout 2010.

[10] "Market income" is defined by StatsCan as total income including employment income, investment income and private pension benefits, but excluding government benefits (e.g. CPP/QPP and EI benefits) and transfers (e.g. child benefits).

[11] Note that the bottom half of the tax filers includes many individuals who pay no income tax at all.

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Key Takeaways for McDowall Associates Clients:

12. On a per dollar basis, the high income earners paid nearly double the income taxes that the AIW group paid.

13. Hitting high income earners ever harder will not solve Canada's debt problems.

14. Executives have difficulty reducing the taxes they have to pay on their employment income, even with professional help.

The income taxes paid in 2010 by the two groups are summarized in Table 4 below:

Table 4

	Top 0.01 Percent Tax Filer Group	50th to 90th Percentile Tax Filer Group	High Income Earner Tax Ratio
Number of tax filers	2,550	10.2 million	
Average tax paid	$1,782,000 (31.3%)	$6,875 (15.2%)	259 to 1
Total taxes paid by the group	$4.5 billion	$70.0 billion	1 to 15.5

McDowall Associates Observations

Table 4 illustrates that the average top 0.01% income earner paid the same amount of income tax in 2010 as did a total of 259 other individual Canadians earning from $22,600 to $82,600, reinforcing in our view the importance of attracting, retaining and motivating high income individuals in Canada.

Expressed differently, the High Income Tax Ratio in Table 4 represents 193%, or nearly double, the High Income Earner Pre-Tax Ratio in Table 3. In addition, some 655,000 individuals in the 50th to 90th percentile tax filer group were needed to come up with the total taxes of $4.5 billion paid by the 2,550 high income earners.

While there are significant differences between the CEO and AIW tax estimates shown in Table 2 and the income taxes reported by StatsCan for the High Income Earner group and for the 50th to 90th Percentile Tax Filer group in Table 4, the conclusion is the same: high income earners pay a lot of tax, in fact about twice as much per dollar of pre-tax income.

One can also conclude from the total tax comparison that a tax hit on high income earners[12] would not in and of itself solve Canada's federal and provincial debt problems, as compared to a small increase in the taxes paid by the average worker.

Even though it is true that individual executives can afford professional tax advice to help them minimize their income taxes, in practice there is not a lot they can do today to reduce the taxes they have to pay on their employment income, due to the ongoing legislative efforts of the Department of Finance and to the assessing practices of the Canada Revenue Agency over the past several decades, as summarized in the Appendix.

[12] Such as the extra 2.0% base income tax rate introduced in July 2011 by Ontario on taxable income in excess of $500,000 (which is actually 3.12 % when Ontario's surtaxes are included).

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About McDowall Associates

Fully Independent Experts

McDowall Associates is a fully independent consulting firm offering a complete range of advisory services for Boards and management.

Strategic & Evidence-based Approach

Providing market intelligence based on research is foundational to the consideration of alternative strategies.

Subject Matter Experts

Experience matters! Our associates have in-depth knowledge of executive compensation and related areas of practice including Expert Witness Consulting.

Conclusion

Despite its shortcomings, there is a good possibility that disclosure of the CEO Pay Ratio will be mandated in Canada at some time in the future as a "good governance best practice". Recall, for example, that "say on pay" was at one time thought to be superfluous and unnecessary. In the interim, we believe organizations should determine what their CEO Pay Ratios might look like and then consider the potential implications should disclosure ultimately be required.

While we know few will feel sorry for Canada's executives because of the absolute amount of pre-tax income they receive, we believe the CEO Tax Ratio is important to consider because it demonstrates the relative significance of their contribution to our economy, both as individual taxpayers and collectively.

Moving Forward

Only 60 executives can be the CEOs of the companies in the S&P/TSX 60 Index of course. Accordingly, in an upcoming McDowall Associates article, we will examine the compensation of the CEOs of the next 60 largest companies in the S&P/TSX Composite Index to see how well they are paid by comparison, and whether their "CEO Tax Ratios" are also significant.

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Appendix: Changes to the Taxation of Employment Income

Date	Income Tax Provision	Implementation	Comments
Longstanding provision	Employee use of employer owned or leased vehicle results in taxable benefit	Subsections 6(1)(c) and 6(2) of the Income Tax Act (ITA)	Limited exclusions apply which are reviewed annually by the Canada Revenue Agency (CRA)
Longstanding provision	Companies cannot take a tax deduction for the value an employee receives on exercising a stock option	Paragraph 7(3)(b) of the ITA	Lack of company tax deduction is effectively the “quid pro quo” for allowing employees to claim the 50% stock option deduction
1971	Country club and golf club membership fees can no longer be deducted by employers	Subsection 18(1)(l) of the ITA	These memberships may also be taxable to employees
1986	Salary deferral arrangement (SDA) rules first introduced	Federal budget amendments to various ITA sections ITA regulation 6801 exemptions (e.g. deferred stock units)	Deferred compensation will be taxable in year earned, unless an allowable exemption applies. Bonuses can be deferred, but for no more than 3 years
1986	Retirement compensation arrangement (RCA) rules first introduced	Press release, followed by amendments to various ITA sections	Prefunding of supplementary executive retirement plans (SERPs) allowed, but not very tax effective
1989	Limits imposed on allowable retiring allowance transfers to RRSPs	Federal budget amendments to ITA paragraph 60(j.1)	Based on length of employee service and pension plan or deferred profit sharing plan participation
1994	All employer paid group life insurance premiums become tax-able to employees	Federal budget amendment to ITA subsection 6(4)	Previously premiums for the first $25,000 of coverage were not taxable
1994	Only 50% of the cost of a meal or of entertainment can be deducted by the employer	Federal budget amendments to ITA paragraph 67.1(1)	Previously 80% of the cost could be deducted
1995	Retiring allowance transfers to RRSPs no longer allowed for service after 1995	Federal budget ITA amendment	Transfers now increasingly capped
2006	Canada employment credit	Federal budget ITA amendment	$1,000 non-refundable federal tax credit
2007	A SERP could be considered to be a SDA (and thus currently taxable) by CRA if the terms of the SERP are more generous than those under the basic pension plan	CRA announcement at a Canadian tax conference in response to a question	The Department of Finance agreed with CRA’s position at the conference
2010	Immediate tax withholding required on all stock option exercises	Federal budget ITA amendments	Withholdings required regardless of how the option exercise is settled
2010	Tax effectiveness of tandem stock appreciation rights (SARs) effectively eliminated	Federal budget ITA amendments	Previously the company could take a tax deduction and the employee could claim the 50% stock option deduction

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