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Remuneration planning for the corporate owner: tax considerations for accessing your corporate earnings

Remuneration planning for the corporate owner is an area that has significantly changed over the past number of years. As businesses progress, family priorities evolve and tax rates and laws change, annual tax planning should also be reviewed. Those who are proactive with their planning will be better positioned to reduce their overall tax burden and potentially provide additional capital to grow their business.

The Canadian tax system is built on the principle that fully distributed corporate income should be taxed roughly the same as if the income were earned directly by an individual owner. This concept is referred to as "integration." If corporate and personal tax rates were perfectly aligned, we would have a fully integrated system and there would be less opportunity for planning. However, since federal and provincial tax rates are constantly changing and there are various types of income (e.g., investment income, active business income), it is rare to find income that is perfectly integrated; thus, opportunities for planning exist.

Another feature of the Canadian tax system is an incentive to retain active business profits inside the corporate group. The incentive provided is a deferral of overall taxes to the extent that active business profits are not distributed to the corporate owner. For most private corporations, this incentive doesn't exist for investment income earned in the corporate group because of the application of the refundable tax system (to be discussed later).

To illustrate by way of an example, assume the following facts:

- Personal tax rate of 50% on ordinary income
- Personal tax rate of 33.33% on eligible dividends
- Corporate tax rate of 25%
- $1 million of business income is earned

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The above rates would result in a fully integrated tax system for business income. That is, should the corporate owner take a salary of $1 million, the owner would be left with $500,000 after personal taxes. If the corporate owner didn't take a salary, the corporation would pay $250,000 of tax and have $750,000 of remaining funds to pay as an eligible dividend. When that eligible dividend is paid out to the corporate owner, an additional $250,000 of personal taxes would be paid, and the corporate owner would have $500,000 available after all taxes.

Reducing the current and future tax burden: basic considerations

Maximize the tax deferral — Continuing the example above, the overall tax burden is $250,000 less if the after-tax funds ($750,000) are not distributed from the corporation as an eligible dividend. Therefore, a tax deferral (a maximum of $250,000 in this example) can be achieved by leaving funds in the corporation. Normally, the corporate owner needs access to some capital for personal living costs and so will want to maximize the tax deferral. Here are some common ways to do so:

- Use available personal funds rather than drawing funds from the corporate group.
- Draw on tax-paid shareholder loans prior to taking taxable distributions from the corporate group.
- Review corporate group tax balances to determine whether any of the corporations have a capital dividend account (CDA). A CDA is generally created when a corporation receives a capital dividend, realizes a capital gain or receives life insurance proceeds. To the extent a CDA exists, a tax-free dividend could be paid to the corporate owner instead of a taxable dividend.
- Consider the use of a shareholder "debit" loan account (where the corporation has a receivable from the individual shareholder). Shareholder debit loans must be repaid within one year after the end of the year in which the loan was made, or else the loan will be included in the business owner's income in the year funds were withdrawn. However, the shareholder may be able to repay the loan within the required timeframe and avoid a taxable distribution. The repayment of a shareholder loan cannot constitute a series of loans or other transactions and repayments if the one-year repayment is to be considered valid. The use of an interest-free shareholder debit loan will cause a nominal income inclusion at the prescribed rate (currently only 2%). Therefore, the tax cost of using the loan strategy could be less than 1% instead of the tax cost of a dividend.

- Consider transferring non-personal-use assets (such as portfolio investments or real estate rental properties) into the corporate group. Such transfers can normally be done on a tax-deferred or taxable basis. Since the tax on capital gains may be lower than the tax on a dividend distribution, the corporate owner should review whether an election to defer a capital gain is desirable.
- Consider transferring personal-use assets (such as a vacation property) into the corporate group. It should be noted that if the corporate owner has access to and use of corporate property without payment, a shareholder benefit would normally exist. The amount of the benefit and tax cost from the benefit should be reviewed alongside the amount of tax that would otherwise be payable on a taxable distribution.

Reduce the cost of taxable distributions — The example above suggested a personal tax rate of 50% on ordinary income, and 33.33% on eligible dividends. These rates approximate the maximum tax rate in most provinces. However, tax rates in Canada are lower if the individual's total income is lower. In general, it isn't until after personal income exceeds $200,000 for the year that the maximum tax rates are reached. Here are some tips that may be helpful in reducing the cost of taxable distributions:

- Consider paying a reasonable salary to other family members for services provided to the corporate group (one example is administrative or marketing duties). If the individual receiving the salary is in a lower tax bracket than the corporate owner, an overall savings would be realized. For the salary to be deductible by the corporate group, it will need to be reasonable for the services provided.[1]
- Review whether the corporation should pay an eligible dividend (as opposed to a non-eligible dividend). A corporation can pay eligible dividends to the extent it has a general-rate income pool (GRIP). A GRIP balance is generally created when a corporation pays the general rate of tax on business income or when the corporation receives an eligible dividend from another corporation. The tax savings from paying an eligible dividend will vary depending on the individual's taxable income and province of residence. In some cases, there will be no savings; in others, the savings could be in excess of 10% of the amount of the dividend.
- Review whether the corporation has a refundable dividend tax on hand (RDTOH) account. An RDTOH account is generally created when a private corporation earns investment income, realizes a capital gain or receives a dividend from a connected corporation that had an RDTOH account. If a corporation has a balance in the RDTOH account, it will receive a refund of taxes when it pays taxable dividends. The refund amount is 38.33% of the taxable dividends paid. A recovery of corporate taxes through the RDTOH account could offset the personal taxes payable on the dividend, and in some cases, the refund amount will be more than the personal taxes owing. The 2018 federal budget introduced legislation to limit the ability to recover RDTOH with the payment of eligible dividends. The new legislation is effective for taxation years beginning after 2018. Some planning in this regard could be available (as discussed later in this article).
- Consider whether other family members should be equity shareholders within the corporate group so that discretionary dividends could be paid to individuals in a lower tax bracket than the corporate owner. Such planning will need to be reviewed alongside the new income-sprinkling legislation that was introduced in 2017 and is effective as of the 2018 calendar year (see below).
- Consider future income and cash flow needs in conjunction with the current year. Since maximum tax rates are not generally reached until income exceeds $200,000, it is often more beneficial to ensure the lower tax brackets are maximized each year and avoid a larger distribution, at a higher tax rate, in a future year.

Income-sprinkling legislation for 2018 and later years

New legislation (introduced in 2017 and enacted in 2018) has broadened the base of individuals affected by, and increased the types of income subject to, the tax on split income . Before 2018, this tax applied only to minors and was commonly known as "the kiddie tax." In essence, the new rules limit income-splitting opportunities with adult family members through the use of private corporations after 2017.

Beginning in 2018, any income received by an individual that is derived directly or indirectly from a related private company (with the exception of salary) could be subject to tax on split inocme (TOSI). Any income subject to TOSI will be taxed at the highest marginal tax rate, which eliminates any tax advantage. To avoid the application of TOSI, the type of income or the individual receiving the income must meet one of the specific exclusions provided in the legislation. The application of the rules will also depend on the age of the individual receiving the income.

Exclusions are provided for recipients who are actively engaged in the business, payments that represent a reasonable return (based on a number of factors) and payments received by certain shareholders. Certain other exclusions also apply. For more information, refer to EY Tax Alert 2017 Issue No. 52, *Finance releases revised income splitting measures,* and *TaxMatters@EY* articles for February and May.

[1] For example, salaries comparable to what arm's length employees would be paid in a similar capacity.

Other planning ideas and considerations relevant to corporate-owner remuneration

Other planning ideas — The areas discussed above are some of the more common plans that require minimal corporate transactions to be undertaken. In some cases, corporate owners may have already maximized the deferral of tax and wish to further minimize the tax on distributions from the corporate group. The following comments should be kept in mind when developing an overall strategy:

- It's important to remember that capital gains are taxed more favourably than dividend distributions. While the *Income Tax Act* does contain rules to deem amounts received from a corporation to be dividends, these rules have been found not to apply in all cases. Corporate owners may want to check whether they have any assets with unrecognized capital gains and whether those assets can be transferred to a corporation so that tax-free shareholder loans are created.
- As mentioned previously, corporations can have an account called a CDA that permits tax-free dividends to be paid to the corporate owner. The CDA is generated when the corporation realizes a capital gain. Corporate owners could review the assets inside their corporations to determine whether it is advisable to realize any capital gains. In situations where the corporate owner wishes to take distributions from the corporation, it may be tax efficient to recognize the capital gain inside the corporation to take full advantage of the CDA.

Other considerations — Other points to consider when determining remuneration for the corporate owner include the following:

- If funds are needed for personal consumption, the Canada Revenue Agency (CRA) has a longstanding policy of not challenging the reasonableness of remuneration if the recipient is active in the business and a direct or indirect shareholder. This criterion of reasonableness is relevant when considering whether the remuneration is deductible to the paying corporation. It is generally more advantageous to distribute corporate profits as a salary or bonus to an active owner-manager on the basis of current provincial corporate and personal tax rates. However, this may not be applicable for all provinces, and certain provinces levy additional payroll taxes, such as Ontario's employer health tax, which may affect an analysis of the optimal compensation strategy.
- Salaries and wages require payroll remittances of income taxes, Canada Pension Plan (CPP) premiums and potential employment insurance (EI) premiums. These remittances are due (depending on the corporation's total remittances) shortly after the payment of the remuneration. Failure to remit on time carries penalties (up to 10% of the remittance) and interest that could be significant. Dividend payments do not require payroll remittances. The payroll taxes of CPP and EI also represent a real cost to the corporation and the individual and should be considered in the overall strategy.
- Bonuses declared in a corporation's fiscal year can be deducted as long as they are paid within 180 days of the year-end. If the corporation has a December year-end, the corporate deduction for a bonus could be taken in the December tax return, but the payroll remittance and the personal taxes applicable to the bonus wouldn't be payable until the following year.
- Payment of dividends to the corporate owner will generally result in a personal tax instalment requirement for the following year. Failure to make personal tax instalments will result in interest and penalties.
- Dividends do not represent earned income for purposes of generating registered retirement savings plan (RRSP) room or for purposes of deducting child care or moving expenses. If RRSP room is desirable or child care or moving expenses are applicable, some salary should be considered.

Items that require more immediate attention for 2018

Review of corporate shareholdings — While not discussed in detail in this article, the new income-sprinkling legislation effective for 2018 and later years does contain several exceptions and exclusions from the expanded definition of "split income." One of the main exclusions is for individuals who are 25 years of age or older and directly own 10% or more of the shares (by votes and value) of certain private corporations. The legislation provides that as long as these shares are owned by the end of 2018, the test will be met for the entire year.

Corporate structures should be reviewed before the end of December to ensure that family members intending to rely on the 10% votes-and-value exception will own the shares by the end of the year. It should be noted that the exclusion does not apply for shares held through a family trust, shares of a professional corporation or shares of a service corporation. In many cases, family members will own the shares through a trust or in an ineligible corporation. It's not too late to make the appropriate changes.

Match GRIP with RDTOH accounts — As previously mentioned, legislation was introduced in the 2018 federal budget to restrict the recovery of RDTOH with the payment of eligible dividends. The legislation itself is not the subject of this article; however, it is generally effective for taxation years that begin after 2018, so many corporations have only a few weeks to minimize the impact of the new rules.

The new rules provide for some grandfathering to the extent that a corporation has both a GRIP balance and an RDTOH balance. These corporations will be permitted to recover their existing RDTOH by paying eligible dividends in the future. In some corporate structures, one company (maybe the operating business) has the GRIP balance and another corporation (maybe the holding corporation) has the RDTOH balance. For corporations to take advantage of the grandfathering provided, these balances should be matched in the same corporation so that eligible dividends will be able to be paid to recover the existing RDTOH. The transactions required to match the two tax balances will depend on the existing structure, and business owners should be encouraged to review the implications of the new rules with their tax advisor.

Learn more

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