TAX LETTER

August 2023

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SHAREHOLDER REMUNERATION: AN OVERVIEW

There are many ways a corporation can get corporate funds into a shareholder's hands. The inevitable question is what is the most tax-efficient way of achieving this?

This answer to this question will differ from corporation to corporation, depending on the source of the corporate funds, the relationship of the shareholder to the corporation, and the amount of corporate funds to be distributed. However, there are also some generalities in relation to each method of distribution, which may help to determine the most efficient manner of payment from the corporation to the shareholder.

Taxable Dividends

One of the most common ways for shareholders to receive funds from a corporation is through taxable dividends. For a corporation eligible for the small business deduction, the dividends will likely be "non-eligible" dividends, meaning that the shareholder will be subject to a relatively high rate of tax because the corporation will

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have benefited from the lower small business tax rate on the underlying revenue.

In a standard comparison between the payment of a taxable dividend and the alternative of a salary payment, the dividend option will usually lead to a greater amount of "in the pocket" income after all taxes are accounted for. For example, $100,000 of corporate revenue paid out to a shareholder in Ontario, assuming the shareholder has no other income in the year, will result in approximately $75,000 net income in the shareholder's pocket after all corporate and personal taxes are paid.

By contrast, the same amount of corporate income, paid out as a salary, will result in about $67,000 net income after all taxes are paid. This is largely due to the additional CPP and EI amounts that both the corporation and the individual must pay on a salary.

However, tax is not the only consideration when making a dividend-salary decision. There are financial downsides to relying solely on dividend income. For example, dividend income does not count as earnings for RRSP contribution room purposes. Also, dividend payments do not allow for contributions to CPP, meaning a likely reduced Canada Pension in the future if the shareholder does not have any other source of salary or business income in the year.

In addition, if the shareholder intends to take out a mortgage in the near future, they may find that lenders will refuse to lend based on a recent financial history that relies solely on dividends, which are discretionary and can be manipulated. Banks tend to favour a financial history showing a stable, contractual, source of income.

A corporation paying dividends in a year must issue the shareholder a T5 slip, which must be filed with the Canada Revenue Agency (CRA) by the end of the following February.

Salary

As mentioned above, salary payments usually mean less after-tax income in the shareholder's hands. However, there are several non-tax benefits, such as (future) CPP benefit, RRSP room, and a helpful financial history for borrowing purposes.

There is also a net corporate benefit to the payment of a salary, as such payments are usually deductible when calculating the corporation's tax liability for the year. Care should be taken to ensure that any salary paid fairly reflects the contributions of the shareholder to the company, however, as any salary considered unreasonable in the circumstances may not be deductible to the corporation, creating a double tax scenario.

When a salary is paid to an owner-manager, the CRA are generally less likely to challenge the amount of salary paid, provided that the owner is actively involved in the business.

Salary payments must be reported on a T4 slip, which must be filed with the CRA by the end of the following February. There are also strict payroll deduction, filing and

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remittance obligations with which the corporation must comply. Therefore, paying a salary comes with an ongoing administrative burden for the corporation.

Shareholder Loan

For short-term shareholder cash requirements, owner-managers often simply take cash out of the corporation when needed. Business records in relation to such withdrawals are often not kept up-to-date. In some cases, records of the loan amounts may be lacking entirely.

This practice is generally not recommended, as there are tax rules that seek to ensure tax is not avoided through the making of a corporate loan rather than a taxable dividend or salary payment.

While loans from a corporation to its shareholders are permitted, they cannot remain outstanding indefinitely without adverse tax implications arising. The Income Tax Act (ITA) contains a rule that a shareholder loan must be repaid within one year of the end of the corporation's tax year in which the loan was made. For example, a loan made by a corporation on August 31, 2023, where the corporation has a December 31 year end, would need to be repaid by the shareholder by December 31, 2024 to avoid any negative tax consequences.

If the loan remains outstanding after that time, the amount of the loan is included in the shareholder's taxable income in the year in which the loan was made, and is taxed at the same income tax rates as salary. In the above scenario, the outstanding loan would be included and taxed in the shareholder's 2023 T1 tax return.

Although taxable to the shareholder in the year the loan is made, a deduction is available to the shareholder for the same amount, but only in the year when the loan is eventually repaid.

If the loan is not included in income – for example, it is repaid on time – then for the time the loan is outstanding, the ITA deems **interest** to accrue on the loan to the extent any interest paid by the shareholder is less than the "prescribed" interest rate (currently 5%). This interest must be paid within 30 days of the end of the year; otherwise the outstanding amount will be taxed as a taxable benefit arising to the shareholder. Note that this deemed interest arises from the date of the making of the loan.

Given the tax consequences of an outstanding shareholder loan, many advisers caution against such loans (or at least recommend keeping detailed records of withdrawals and ensuring that outstanding loans are repaid, and any deemed interest paid, before any taxable benefit arises).

Outstanding loans are commonly "repaid" through declaration and payment of a dividend to the shareholder (by way of a credit to the shareholder's loan account with the corporation) at the end of the corporation's tax year.

Capital Dividend Account

An often-overlooked source of tax-efficient shareholder remuneration is the corporation's capital dividend account (CDA).

The CDA of a corporation tracks all capital gains and losses realized by the corporation over its lifetime. Just as with individuals, only one-half of capital gains arising to a corporation are taxable.

The non-taxable portion of corporate capital gains (and non-allowable portion of capital losses) are recorded in the CDA. As the CDA balance tracks non-taxable income within a corporation, any balance in this account can be paid out tax-free to shareholders.

Common sources of capital gains and losses arising to a corporation come from the sale of business assets, as well as the sale of portfolio investments held in the corporation.

The CDA is a running account of all capital gains and losses. Therefore, it is the *net* capital gain/loss position that forms the CDA balance, and determines the amount that can be paid out tax-free to shareholders.

The timing of a capital dividend payment can be important if, for example, a large capital sale is planned which may realize a substantial loss. In this situation, a capital dividend payment before the sale may be advisable.

When paying a capital dividend to a shareholder, form T2054 must be filed immediately with the CRA – by the day the dividend becomes payable or is paid. A current CDA calculation and a certified copy of the directors' resolution declaring the dividend must also be provided with the form.

In the absence of any election to the contrary, if the capital dividend paid exceeds the amount in the CDA at the time of payment, the corporation will be taxed on the excess amount at a rate of 60%.

Therefore, care must be taken when calculating the CDA before paying a capital dividend. As a back-up, it is possible to include in the directors' resolution, a resolution electing to treat any dividend amount in excess of the CDA balance as a separate dividend. This would avoid the 60% tax rate, although the excess amount would still be taxed as a taxable dividend.

One planning point regarding the payment of capital dividends, and dividends generally, is that the shareholder recipient would need to have a class of shares separate from the other shareholders on which the dividends could be paid. Dividends are declared on a *class* of shares, which means that all shareholders who hold that class of shares must be paid a dividend equal to their proportionate number of shares of that class. It may therefore be necessary to restructure the corporation's shareholdings in advance, if future remuneration by way of dividends (capital or taxable) is planned.

Capital Gains Planning

As you will note, using corporate capital gains is a highly tax-efficient way to get corporate funds into shareholders' hands. However, in many cases, any gains within the corporation are due to inherent business growth and are sitting, uncrystallized, in the value of the shares themselves.

In most cases, these inherent corporate gains would not be accessible until the underlying shares are sold by the shareholder. This may ultimately only arise on a future sale of the business. However, planning is available in many cases to access these gains without having to sell the corporation.

One form of such planning is the sale of shares to a family member (discussed in the July 2023 Tax letter).

Another type of planning is commonly known as "capital gains stripping". This generally involves a shareholder selling part of their shares to a related corporation, which the shareholder (or another family member) controls, in exchange for a debt owing by the second corporation to the shareholder.

This planning takes advantage of the fact that most dividends paid between corporations are exempt from tax, meaning that the second corporation, which by that time will be a shareholder of the main corporation, can receive tax-free dividends, which it can then use to repay the debt to the shareholder. As the repayment of debt is non-taxable, no tax arises to the shareholder after the initial share sale.

The major downside of this planning is that the shareholder must pay upfront tax on the sale of the shares to the second corporation. An important point to note about this type of planning is that it generally does not work if the shareholder claims their lifetime capital gains exemption on the sale.

However, the tax payable upfront is calculated at the capital gains rate which is a much lower rate of tax than the tax due on a taxable dividend or on salary. For example, the top rate of tax on a dividend in Ontario is 47.74% whereas the top rate of tax on a capital gain is 26.76%. Although the shareholder must bear this upfront tax, often before the sale proceeds are fully received from the second corporation, once this tax is paid all associated future loan repayments are tax-free.

Recent tax changes, including those discussed in previous tax letters and mentioned below, seek to put an end to various types of advantageous tax planning. However, the capital gains strip remains a relatively common, and widely accepted (for now) strategy to remove corporate funds tax-efficiently.

That being said, speculation has been rife for years, and often resurfaces right before federal Budgets, that the Department of Finance will at some point take action to nullify the tax savings available through capital gains stripping. For now though, capital gains stripping is a common planning technique, familiar to many accountants and tax lawyers.

Capital gains stripping is not without risk. The planning required is not as simple as selling shares to a second corporation. The ITA has several anti-avoidance provisions that must be complied with. A number of different transactions must be undertaken prior to the final sale to ensure that the sale is not "caught" by any of these provisions. Falling foul of any of the anti-avoidance provisions will often mean that the capital gain is instead taxed as a dividend. Therefore, professional advice should always be sought before taking any action.

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Although the tax benefits of a capital gains strip are obvious, the planning itself is complex and costly. Therefore, the tax savings available are often outweighed by planning fees, particularly for modest withdrawals. It is unlikely that this planning would be cost-effective for withdrawals of less than six figures.

Payments to Family Members

Up to now, this discussion has assumed that an owner-shareholder wishes to remunerate themself. However, in many owner-managed businesses, it is common that related persons such as spouses and children are also shareholders. This situation allows for further tax savings through the splitting of income across the family. For example, an owner-manager who is already subject to tax at the highest marginal rate, may be able to pass some income to a family member who still has marginal tax bracket room.

Paying dividends to family members also brings into play even more anti-avoidance provisions of the Act which can be particularly complex to navigate. In 2018, updated rules came into effect which restricted business owners' ability to pay dividends to family members. These are known as the Tax on Split Income ("TOSI") rules.

The TOSI rules are complex and generally apply to dividend payments to family members unless the payment falls within one of a number of exceptions to the rules. Where a dividend payment to a family member is caught by the TOSI rules, any benefit of using the family member's marginal tax brackets is lost. Instead, the highest marginal tax rate will automatically apply to the entire amount.

The TOSI rules target situations where family members are shareholders for non-commercial (often tax-planning) reasons. Therefore, a number of the available exceptions provide relief for situations where the family shareholding is a genuine commercial holding.

One of the most commonly-used exemptions is the "excluded business" exemption. Under this exemption, a dividend payment to a family member will not be caught by the TOSI rules where the family member is actively engaged on a regular, continuous and substantial basis in the business. This test must be met either for the year of the dividend payment or in any five prior years of the business.

The CRA considers a person to be actively engaged in a business where they work an average of 20 hours per week in the business throughout the year. Alternatively, if this test is not met, a person may be considered actively engaged in a business if they spend less time than this, but where this lesser time is all that is required for the successful operation of the business in the circumstances (for example, for seasonal businesses).

Another common exception relates to older business owners. Known as the "retirement exclusion", it applies to owners over 65 and who pass corporate income to their spouse. This exemption recognizes the rules that allow couples to split their pension income in later life, and makes corporate income splitting consistent with this.

One condition for the retirement exception to apply is that the income passed to the spouse must not be caught by the TOSI rules if it were paid to the owner directly (i.e. the owner would have to meet one of the other exceptions if they themselves received the income).

Less common is the "reasonable return" exception. This exception recognizes that family members may have genuinely invested in a business. In such situations, any dividends paid to that family member would not be subject to the TOSI rules where the dividend is reasonable, having regard to factors such as capital contributed, work performed and risks assumed by the shareholder.

This is a highly subjective exception. However, where family members have invested significant capital into the business, in the form of a share subscription, this exception permits dividends to be paid to the shareholder without triggering the TOSI rules. A guiding consideration should be what a non-related shareholder could realistically expect to receive by way of dividends, given their contribution.

Note that salary payments are not subject to the TOSI rules. Therefore, it is possible to pay family members a salary from the corporation, which may be advantageous if the family members currently do not use their marginal tax brackets. However, as previously mentioned, any salary paid must be a reasonable salary taking into account the work the family member does for the business. Any portion of a salary considered unreasonable will not be deductible to the corporation, meaning that both the corporation and the family member will pay tax on the salary amount.

MANDATORY REPORTING RULES NOW IN EFFECT

The June 2023 Tax Letter discussed proposed rules regarding mandatory reporting of certain transactions. These rules have now passed through Parliament and received Royal Assent, and came into effect, on June 22, 2023.

The rules aim to discourage and catch "aggressive" tax planning. Although there has been a requirement to report certain types of transactions for some time, the new rules drastically increase the situations and transactions that trigger reporting requirements. These requirements come with significant penalties for non-compliance and apply not only to professional advisors but also to affected taxpayers entering into the transaction, or who expect to receive a benefit from the transaction.

Please consult the June 2023 Tax Letter for more on these rules

AROUND THE COURTS

Business expenses disallowed for lack of supporting evidence

In *Papouchine v. The King*, 2023 TCC 8, the taxpayer sought to claim over $63,000 of business expenses in his tax return, including motor vehicle, sub-contracting and interest expenses. The case itself involved other issues, including whether the taxpayer was an employee or a contractor, but the

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Court dealt with the expense issue simply and swiftly.

The taxpayer provided no documentary evidence to support the expenses, such as invoices or evidence of a sub-contracting relationship. The Court reminded the taxpayer that the Income Tax Act "requires every person carrying on business to keep relevant business records". In the absence of such records, the Court did not allow any deduction.

This case highlights that records must be kept for every expense claimed on a tax return. This applies not only to business expenses, but also to deductions such as medical expenses and charitable donations. Although this evidence does not have to be submitted to the CRA with the return, the CRA may request this evidence upon review or audit, and may deny the expenses claimed if evidence is not provided.

Generally, business records should be kept for 6 years following the year to which they relate. More information on record-keeping requirements can be found at this link.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.