

# THE NAVIGATOR



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## TAXATION OF BUSINESS INCOME AND METHODS OF WITHDRAWING CASH FROM A CORPORATION

### Surplus Cash in a Corporation – Part 3

As the owner-manager of your operating company, you may have surplus profits accumulating in your corporation. This surplus cash could be in your operating company or it could be in your holding company. In either case it is still a corporate structure and the tax implications are the same.

Your first reaction may be to figure out how to withdraw the funds from the corporation and pay as little income tax as possible. While this might seem like the best solution, other options might be more appropriate depending on your situation and your personal and business needs.

There are many issues to consider when deciding what to do with your corporation's surplus funds. What do you need the money for most? What options are available? And what are the tax implications of those options?

The third article of the surplus cash series discusses ways you can withdraw the cash from your corporation and the tax consequences of withdrawing the funds.

This four-part series takes you through some of the key issues to consider when you have surplus cash in your corporation:

**Part 1:** Decision tree for addressing surplus cash in a corporation

**Part 2:** Taxation of investment income

in a corporation

**Part 3:** Taxation of Business Income and Methods of withdrawing cash from a corporation

**Part 4:** Retirement and estate solutions using excess funds in a corporation



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If you need the corporation's surplus funds for personal use, there are different ways you can withdraw those funds, each with different tax implications.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

*The content is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax or legal advisor before you act on any of the information provided in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.*

#### **WHEN THERE'S A PERSONAL NEED FOR THE SURPLUS CASH**

When your corporation has excess funds, you may decide that you need them personally more than the corporation needs them. Some reasons might include:

**Lifestyle expenses** — Your cash flow may be tight if you haven't been paying yourself enough income from the corporation or your situation has changed and you require more personal funds or you have additional costs such as a child's private education, a vacation, etc.

**Income tax** — Depending on whether the corporation pays you dividends or a regular salary, you may need to make income tax instalments personally. If those instalments are not paid on time, you could incur penalties and interest. Also, if your taxable income is higher this year than it was in previous years, you may owe more when you file your

personal income tax return.

**A major purchase** — You may be planning a major purchase such as a new car or a second property.

**Personal debt** — You may have personal debt that is non-tax-deductible and may wish to reduce this debt using surplus cash in the corporation.

#### **WITHDRAWING CASH FROM YOUR CORPORATION**

If you need the corporation's surplus funds for personal use, there are different ways you can withdraw those funds, each with different tax implications. There is likely to be a personal tax cost, depending on the form of payment. The rest of this article discusses some different ways your corporation may pay you and some of the consequential tax issues and incentives that might apply.

#### **REIMBURSING YOU FOR BUSINESS EXPENSES YOU PAID PERSONALLY**

If you personally paid for anything related to your corporation, you can get your company to reimburse you for those expenses. Common examples are using your car for business purposes or entertaining clients with your own money.

When you use your after-tax dollars to pay for business expenses, you don't have to pay any income tax on amounts reimbursed by your corporation. Your company will get the tax deduction for the business expense, but it is important to keep accurate records and receipts.

#### **REPAYING AMOUNTS OWED TO YOU**

Your corporation may owe you because:

- You transferred personal assets to your corporation and received no cash or shares in return

In general, the first \$500,000 of ABI earned by a CCPC is taxed at the favourable small business rate.

- Your company declared a dividend or a bonus and you loaned the funds back to your corporation
- You personally incurred business expenses, as discussed above, but weren't reimbursed by your company

These amounts often accumulate in the start-up phase or low cash-flow periods when your company has insufficient funds to reimburse you. When the corporation repays the loan, the repayment is not taxable.

#### **PAYING A SALARY OR BONUS**

You may consider paying yourself a higher salary or a bonus from your operating company. If your spouse and children help out in the business, consider paying them a reasonable salary for services rendered. This is a great income-splitting strategy that may save your family money if your children or spouse is in a lower tax bracket than you. In addition, a salary or bonus is considered earned income for the purposes of generating RRSP contribution room or qualifying earnings if you ever decide to establish an Individual Pension Plan (IPP).

#### **WHEN TO PAY YOURSELF**

A salary paid by your company is deductible for the corporation; however, any salary received by you is taxable at your personal marginal tax rate. Therefore, it may make more

sense for your company to pay you a salary if it is paying tax at the high general corporate tax rate as opposed to the small business rate. This only applies to an operating company that is earning an income from its business operations, known as active business income (ABI).

In general, the first \$500,000 of ABI earned by a CCPC is taxed at the favourable small business rate. This threshold is known as the small business limit. The combined federal and provincial small business rate varies by province from approximately 11% to 19%. Any income earned by the CCPC above the small business limit is taxed at the higher general corporate rates which, again, vary by province from 25% to 31%. The higher corporate rate is almost double or more than double the small business rate. The federal small business limit is \$500,000, and in most provinces the provincial business limit is also \$500,000, except for Manitoba and Nova Scotia.

It is important to note that this small business limit is reduced for corporations or corporate groups with taxable capital employed in Canada of greater than \$10 million and it is completely eliminated for corporations/corporate groups with taxable capital employed in Canada in excess of \$15 million. This is regardless

of their taxable income. For taxable capital between \$10 and \$15 million the business limit is phased out. What this means is that where a corporation's taxable capital is greater than \$15 million, all their income would be taxable at the higher general corporate tax rate and they would not have access to the favourable tax rates on income below the small business limit.

#### **HOW IT WORKS**

Let's look at a couple of examples to illustrate the tax implications of paying a salary — first assuming that your operating company earns more than the small business limit, and then assuming that it earns less than the small business limit. We will assume that your corporation pays a salary of \$40,000 and we will ignore any other taxes or costs that may apply to the corporation as a result of paying a salary.

If your corporation earns more than the small business limit and assuming that the combined federal and provincial high general corporate tax rate is 31%, paying a \$40,000 salary will result in a tax savings to your corporation of approximately \$12,400.

On the other hand, if your corporation earns less than the small business limit and assuming the combined federal and provincial small business rate is



Under the right circumstances, you may consider personally borrowing funds to invest in a non-registered portfolio outside of your corporation to increase your wealth.

15%, paying a \$40,000 salary will result in a tax savings to your corporation of approximately \$6,000.

In either case, the salary you receive is taxable personally at your marginal tax rate. If we assume that your marginal tax rate is 50%, you would owe approximately \$20,000 in personal tax. In other words, the total corporate and personal tax rate on earning a salary from your corporation would be 50%, which is your personal marginal tax rate since the corporation would not pay taxes on the amount paid to you as a salary (i.e. they would claim a deduction).

This example illustrates that there is a tax cost to withdrawing cash in the form of a salary or bonus from your corporation. In addition, the level of corporate income will influence whether you should withdraw cash as a salary or bonus or use an alternative method.

Note that from the Canada Revenue Agency's (CRA's) point of view, paying a salary to the shareholders of a holding company that earns only investment income (passive income) must be reasonable based on the facts of each particular case. In making this evaluation, they may look at the duties you perform and the time expended in carrying out those duties, the experience and skills necessary to perform your duties and the remuneration paid by other businesses of a similar size to their employees who render similar services. In any case, since a portion of the tax paid on passive income is refundable to the corporation when taxable dividends are paid out to the shareholders, it may make more sense in certain circumstances to pay a dividend as opposed to a salary to recover the refundable portion of Part I or Part IV tax already paid. You

should discuss with your qualified tax advisor whether it is reasonable in your circumstances to pay a salary from your holding company.

#### **BORROWING TO INVEST**

Under the right circumstances, you may consider personally borrowing funds to invest in a non-registered portfolio outside of your corporation to increase your wealth. The financing costs are funded by you, receiving a salary from the corporation. This is a long-term strategy that is ineffective if you need the funds in the short to medium-term.

This strategy requires that you borrow funds personally and invest in non-registered assets such that the interest paid on the borrowed funds is tax-deductible. You then pay yourself a salary equal to the interest cost. The corporation gets a deduction for paying you a salary and you have an income inclusion personally that is offset by the interest deduction so there is no net personal tax impact. Over the long-term, the funds will be drawn from the corporation with no tax-cost and your non-registered investments will hopefully grow in value.

This is a leverage strategy, which is risky and not suitable for all investors. You need to fully understand the concept of "borrowing to invest" and the related risks before implementing such a strategy. Speak with a qualified tax advisor to ensure that this strategy meets your needs and circumstances.

#### **PAYING A TAXABLE DIVIDEND**

Your corporation may pay you a taxable dividend. The dividend is declared by director's resolution and must be recorded in the minutes of the corporation. Once a dividend is declared on a particular class of shares, then all shareholders with that class of shares must receive a dividend.

The Canadian tax system is designed so that the combined corporate and personal income tax paid on income earned through a CCPC and distributed to you as shareholder should equal the income tax that you would have paid if you earned that income personally outside of your corporation.

A dividend is paid with the after-tax dollars of earned in your corporation. That means that the income earned in your corporation is first taxed in the corporation at its corporate tax rate and then the after-tax funds are paid to you as a dividend. You then pay personal tax on the taxable dividend at your marginal tax rate.

It appears that the same income is taxed twice, once in the corporation and then again personally in your hands when funds are withdrawn as a dividend. However, the Canadian tax system is designed so that the combined corporate and personal income tax paid on income earned through a CCPC and distributed to you as shareholder should equal the income tax that you would have paid if you earned that income personally outside of your corporation. This is known as “integration”. However, integration is not perfect and the integrated tax rate is quite different depending on whether your corporation is earning ABI below the small business limit, ABI above the small business limit or investment income.

To further complicate matters, eligible dividend rules were introduced to apply to dividends paid after 2005 by a Canadian corporation to a Canadian resident shareholder where the dividend is designated as an eligible dividend.

Eligible dividends are subject to an enhanced dividend “gross-up” of 38% and a federal dividend tax credit of approximately 15% of the grossed-up dividend. There is also a provincial dividend tax credit available, which differs for each province.

Your corporation can pay eligible dividends to the extent that its income is taxed at the high general corporate tax rate. Although investment income is taxed at a high rate in the corporation, this type of income cannot be paid out as eligible dividends. Investment income earned by an operating company is taxed in the same manner as investment income earned in a holding company, where the investments are not incidental to the business. In general, investment income includes interest, taxable capital gains, rental income,

royalties and foreign income. Your corporation can also pay eligible dividends to the extent of eligible dividends it receives.

Therefore, your corporation can potentially pay both eligible and non-eligible dividends. In general, eligible dividends can be paid from ABI earned in the corporation in excess of \$500,000 and any eligible dividend income received by your corporation. Non-eligible dividends can be with investment income earned in the corporation and ABI that was subject to the small business rate.

Non-eligible dividends are subject to a dividend gross-up of 18% beginning in 2014 (25% before 2014) and a federal dividend tax credit of approximately 11% (13% before 2014) of the grossed-up dividend. There is also a provincial dividend tax credit available, which differs for each province.

Because of the complexity of these calculations, we advise you to consult your qualified tax advisor to track the various types of income earned and the company’s ability to pay you eligible vs. non-eligible dividends.



## ACTIVE BUSINESS INCOME

As discussed previously, the first \$500,000 of ABI earned by your company is taxed at the favourable small business rate and any income earned in excess of \$500,000 is taxed at the higher general corporate rate. For illustration purposes, let's assume that the small business rate is 15% and the high general corporate rate is 31%. Let's also assume that you are at the top personal marginal tax rate of 50% on regular income, 32% on eligible dividends and 36% on non-eligible dividends. This is what the integrated corporate and personal tax rates would look like in our example (see the separate tables provided along with this article for the actual rates across all provinces):

	Corporate tax rate	Non-eligible dividend rate	Eligible dividend rate	Combined corporate and personal tax rate	Tax rate if income earned personally
ABI up to \$500K	15.00%	36.00%		45.60%	50.00%
ABI > \$500K	31.00%		32.00%	53.08%	50.00%

The table above demonstrates that integration of the corporate and personal tax system is definitely not perfect. It also illustrates that when this corporation earns less than the small business limit and the shareholder needs to withdraw funds from the corporation, it may be better to pay dividends rather than a salary or bonus since the combined tax rate of doing so is 45.60% as opposed to 50.00% if they received a salary or bonus. (Remember, this assumes the shareholder is taxed at the highest marginal tax rate.) In this example, if the corporation earns more than the small business limit, the reverse is true. In most provinces the relationship illustrated in the table above exists but you should check your particular province in the separate tables provided. Of course these decisions should not be made in isolation and without the advice of a qualified tax professional.

## INVESTMENT INCOME

The taxation of investment income earned in a corporation is discussed in Part 2 of this series of articles. As mentioned in Part 2 of this series, if your corporation has a refundable dividend tax on hand (RDTOH) balance, it can recover the refundable

taxes paid by paying out a taxable dividend.

## DIVIDEND SPRINKLING AND MULTIPLYING THE CAPITAL GAINS EXEMPTION

Paying dividends to family members and multiplying the capital gains exemption are tax and estate planning strategies commonly employed in practice by shareholders of private corporations that potentially result in significant tax savings. Both of these strategies involve reorganizing your corporation so that your spouse and/or children own shares of the corporation, either directly or indirectly through a family trust. The step-by-step procedures to implement any of these strategies are beyond the scope of this article however the strategies are introduced below.

Since a shareholder does not have to be involved in the day-to-day operations of the business and dividends are not subject to the "reasonability" test unlike salaries and bonuses, paying dividends to family members that are shareholders, either directly or indirectly, can be a useful income-splitting mechanism (sometimes referred to as "dividend sprinkling").

However, you should proceed

with extreme caution if you are implementing this strategy. It is imperative that no dividends be paid to minor children as they are subject to "kiddie tax". Kiddie tax applies when a minor child receives a dividend from a private corporation. The dividend is taxed at the highest dividend tax rate regardless of the child's marginal tax rate and cannot be offset by the basic personal exemption.

Another pitfall to watch out for is corporate attribution. Corporate attribution applies when property is loaned or transferred to a corporation and a spouse or minor child benefits from this transfer. Corporate attribution does not apply in the case where the company is a small business corporation (i.e., 90% or more of its assets are used in an active business).

The \$800,000 (subject to indexation) capital gains exemption available on the disposition of qualified small business corporation shares (QSBC) can be multiplied if you and your family members own shares of your corporation, directly or indirectly. The definition of QSBC shares is beyond the scope of this article. If you need further information please contact

your qualified tax advisor. Each individual shareholder is entitled to claim a capital gains exemption. Instead of only being able to claim \$800,000 of a capital gains exemption, a family of four can claim \$3.2 million, resulting in an additional tax saving of \$800,000 (assuming a marginal tax rate of 50.00%).

For these two strategies (dividend sprinkling and multiplying the capital gains exemption) to work, the dividends and capital gains must be paid or made payable to your other family members. The funds taxed in their hands will not legally belong to you anymore. Therefore, it should be your intention for them to have these funds.

These strategies are complex and there are numerous traps and pitfalls, both from a tax and legal perspective. Consequently, we advise you to get both legal and tax professionals involved to ensure you accomplish your goals and avoid unnecessary headaches when implementing these strategies.

#### **PAYING A CAPITAL DIVIDEND**

A capital dividend is a tax-free dividend. As with all dividends, there is no deduction for the corporation paying the dividend; however, this type of dividend is not taxable in the hands of the recipient.

Your corporation can pay a capital dividend if there's a positive balance in its capital dividend account (CDA), which is a notional account. The CDA does not appear on your company's financial statements, nor does it have to be disclosed anywhere. However, it should be closely monitored to allow you to take advantage of any tax-free capital dividends. Some corporate tax software packages allow you to

calculate and track the CDA balance annually.

The capital dividend account is affected by the following:

- It is increased by the non-taxable portion of capital gains realized by the corporation.
- It is reduced by non-deductible capital losses realized by the corporation.
- It is increased by any capital dividends received by the corporation and decreased by any capital dividends that the corporation pays.
- It is increased by life insurance proceeds in excess of the policy's adjusted cost base.

It is possible for the CDA to be negative.

A capital dividend is declared by a directors' resolution and by filing a prescribed election (Form T2054) with the CRA on or before the earlier of the date the dividend becomes payable or is paid.

Once a capital dividend is distributed to shareholders, the CDA is reduced by the amount of the capital dividend paid. Generally, it is beneficial to immediately pay a capital dividend whenever the CDA is positive so that the opportunity is not lost in cases where the corporation realizes a capital loss in the future. As mentioned above, you can only pay a capital dividend up to the positive balance in the CDA.

#### **REDUCING THE PAID-UP CAPITAL**

The paid-up capital (PUC) of your shares represents the consideration the corporation has received in return for the shares it issued (this may not be the same as the adjusted cost base). For example, if you contribute assets worth \$20,000 to your corporation, you could

receive shares with a PUC of \$20,000. You would have used after-tax personal dollars to buy the assets originally, so you should be able to get that money back from your corporation without triggering further tax.

In general, the PUC amount is the value assigned to the shares as disclosed on your company's balance sheet. A large value may indicate that you can remove some cash from the corporation on a tax-free basis.

You can reduce the PUC by having the directors declare and pay a dividend as a return of capital then reducing the paid-up capital on the balance sheet accordingly.

It is possible that the PUC for tax purposes is different from the PUC for accounting purposes, and this calculation can be quite complex. In addition, reducing the PUC of the corporation and paying out a tax-free dividend can have other negative tax consequences. Consequently, you should consult with a qualified tax professional to determine if reducing the PUC is appropriate in your particular circumstances.

Determining the most appropriate method or combination of methods to withdraw corporate funds is not easy. It involves an understanding of the general corporate tax structure, an understanding of your corporation's tax details and an understanding of your and your family's specific personal tax details. You should always consult a qualified tax professional for this type of planning.

#### **SHAREHOLDER LOANS**

You may be asking, if I need to access money from my corporation, why not simply borrow it?

Please contact us for more information about the topics discussed in this article.

The Income Tax Act contains very specific rules limiting the ability of a shareholder to borrow funds from their corporation. The general rule is if you borrow funds from your corporation and the loan is not repaid within one year after the end of your corporation's fiscal year-end in which the loan was made, then the amount borrowed is included in your personal income in the year you borrowed the money.

For example, if your corporation's year-end is December 31 and you borrowed money on November 1 of year 1, you would have to be repay that loan by December 31 of year 2, to avoid the income inclusion in your personal income for year 1.

In situations where you are subject to the income inclusion, you will get a deduction on your personal tax return in the year you repay the loan. It is not possible to avoid these rules if you borrow funds, repay it within the time frame allowed, but then immediately

re-borrow the funds. This is known as a series of loans and repayments, and this would not avoid the income inclusion rule.

There are four exceptions to the income inclusion rules (there are others but they are outside the scope of this article). However, these exceptions apply only if the loan is made to you in your capacity as an employee and not as a shareholder. In addition, at the time the loan is made, bona fide arrangements must be made to repay the loan within a reasonable time.

The first exception to the income inclusion rules is a loan made to an employee/shareholder that owns less than 10% of the shares of the corporation. The other three exceptions apply to loans for very specific purposes: the purchase of a home, the purchase of a car for use in carrying out the duties of employment, the purchase of treasury shares of the corporation. To reiterate, for all these

four exceptions to apply, the loan must have been made to the shareholder in their capacity as an employee and not because of their shareholdings.

If you meet the exceptions or the loan is repaid in time so that there is no income inclusion, you may still have a deemed interest benefit that is taxable to you if the loan is a no- or low-interest bearing loan. The shareholder loan rules are complex. Speak with a qualified tax advisor if you wish to borrow from your corporation.

## CONCLUSION

The integration of corporate and personal tax systems are quite complicated but there are many opportunities for planning. Because of the complexity, we strongly advise you to involve qualified tax and legal professionals to maximize these opportunities so that you may effectively accomplish your goals.