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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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# Withdrawing surplus cash from a corporation

As a business owner, you may have surplus cash accumulating in your corporation. Is there a business need for the cash? Or do you need the funds personally and wish to withdraw them from your corporation? What is the most tax-efficient way of withdrawing funds? This article discusses various methods of withdrawing cash from your corporation as well as the tax issues and benefits that might apply with each method.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of the CCPC can be listed on a prescribed stock exchange. This article does not apply to public corporations or to businesses operating as a partnership or a sole proprietor. The tax rates referenced in this article are current as of July 2018 and are based on federal and provincial legislation.

## Withdrawing cash from your corporation

If there is no business need for the excess cash within your corporation, consider whether you have a personal need for the funds such as funding lifestyle expenses or purchasing a vacation property. If you have a personal need for the surplus cash in your corporation, the next step is to determine the best way to withdraw the money, paying special attention to the tax consequences. Some methods of withdrawing cash from your corporation are taxable and some could be tax-free.

## Taxable withdrawals

### Paying a salary or bonus

#### At the corporate level

A salary or bonus paid by your corporation is generally considered a deductible expense and will lower your corporation's taxable income. The level of corporate income will often influence whether your company should pay you a salary or bonus as opposed to an alternative

form of compensation. For instance, it may make more sense for your operating company, earning active business income (ABI), to pay you a salary or bonus if it is paying tax at the high general corporate tax rate as opposed to the small business rate. This allows your company to get a deduction from their income at a higher corporate rate.

There is an additional cost to your corporation in the form of payroll taxes when it pays a salary or bonus. Your corporation has to match an employee's contribution to the Canada Pension Plan (CPP)/ Quebec Pension Plan (QPP). You and your corporation may not have to contribute to the Canada's Employment Insurance (EI) program where you, as an employee, are also a shareholder. Generally EI premiums are not required for an employee who is also a shareholder controlling more than 40% of the voting stock of the corporation. Voluntary participation is permitted.

Salary paid by your corporation may attract other payroll expenses such as provincial workers' compensation and health tax (depending on the province/territory in which your corporation is located and the thresholds in that province/territory).

## Reasonableness

In order for a salary or bonus payment to be deductible, the amount paid must be reasonable. For business owners of an operating company, reasonableness is generally not an issue provided you, as the owner-manager, are actively engaged in the operations of the corporation and contribute to the profits earned by the corporation using your special know-how or entrepreneurial skills.

The Canada Revenue Agency (CRA) has given no specific guidelines in order to determine the reasonableness of salaries or bonuses paid to owner-managers of holding companies that earn substantially all investment income (passive income). The amount, if any that is considered reasonable must be based on the facts of each particular case. In making this evaluation, the CRA may look at the duties you perform and the time spent in carrying out those duties. They may also look at the experience and skills necessary to perform your duties as well as 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 taxes already paid to the CRA if your corporation has significant investment income. If you are considering paying yourself a salary from your holding company, you should consult with your professional tax advisor to determine whether doing so makes sense in your circumstances.

A salary or bonus is considered earned income for the purposes of generating RRSP contribution room and qualifying earnings if you decide to establish an Individual Pension Plan (IPP).

### At the individual level

The gross amount of your salary or bonus (before source deductions) is employment income and is subject to tax at your marginal tax rate in the year it is received. You may be eligible for non-refundable tax credits in addition to the basic personal amount. Some of the federal non-refundable tax credits include a credit for CPP/QPP contributions made by you personally and the Canada employment amount.

A salary or bonus is considered earned income for the purposes of generating RRSP contribution room and qualifying earnings if you decide to establish an Individual Pension Plan (IPP).

## Planning strategies using a salary or bonus

### Income splitting

If your spouse and children participate in the business, consider paying them a reasonable salary for services rendered. Your corporation may be entitled to a deduction for the salary paid and your family members will include the salary in their income. This is an income-splitting strategy that may reduce your family's overall tax bill if your spouse or children are in a lower tax bracket than you. Further, the salary income will be considered earned income and help your family members generate RRSP contribution room. Please note that if the salary is not considered reasonable, your corporation will not be entitled to a deduction for the salary paid while your family members will still be required to include it in their income. This may result in double taxation.

### Borrowing to invest

Under certain circumstances, you may consider personally borrowing funds (e.g. from a financial institution) to invest in a non-registered portfolio outside of your corporation to increase your wealth. This is generally a long-term strategy that may not be effective if you need the funds in the short- to medium-term.

If you are borrowing money to invest in income-producing assets, the interest paid on your borrowings may be tax-deductible to you. You would need to pay yourself a salary

at least equal to the interest cost of your borrowings. Your corporation would be entitled to deduct the salary paid and you would have an income inclusion personally that is offset by the interest deduction related to the borrowings. With this strategy, over the long-term, you will be able to continue withdrawing funds from your corporation in a tax-efficient manner and your non-registered portfolio of investments will hopefully grow in value. Please note that this strategy may not be available to you if you live in Quebec since the provincial tax laws limit the interest you may deduct in any given year to the investment income you earn in that year.

Using borrowed money to finance the purchase of securities involves greater risk than using your existing resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by the terms of the loan remains the same even if the value of the securities purchased declines. Before implementing this strategy, it is important to understand the concept of borrowing to invest and all the related risks. Speak with a qualified tax advisor to determine if this strategy is suitable for you.

## Paying a taxable dividend

You can withdraw funds from your corporation by having your corporation declare a dividend. Once a dividend is declared on a particular class of shares, all shareholders with that class of shares must receive such a portion of the declared dividend in proportion to the number of the shares held.

A dividend payment is not subject to the reasonableness test. Instead, corporate solvency tests may need to be used and restrictions on the capital stock itself should be identified when determining whether a dividend can be paid and the amount of the dividend that can be paid.

### At the corporate level

A dividend payment is not a deductible expense for your corporation. Dividends are paid out of your corporation's after-tax retained earnings, which means they have already been subject to a level of tax within the corporation. When your corporation pays you a taxable dividend, it may receive a refund of taxes for a portion of the taxable dividends it pays.

Canadian corporations may pay both "eligible" and "ineligible" dividends.

## Eligible dividends

An eligible dividend is a taxable dividend that your corporation designates to be eligible. Your corporation can pay eligible dividends to the extent that its ABI is taxed at the high general corporate tax rate. Although passive investment income (which includes interest income, foreign income, rental income, royalty income and taxable capital gains) is taxed at a high rate in the corporation, this type of income cannot generally be paid out as eligible dividends.

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Your corporation can also pay eligible dividends to the extent of the eligible dividends it receives.

## Ineligible dividends

An ineligible dividend is a taxable dividend that your corporation has not designated to be eligible. Your corporation can pay ineligible dividends to the extent that its ABI is taxed at the small business corporate tax rate. It can also pay ineligible dividends from passive investment income that was earned in the corporation.

### At the individual level

You pay personal tax on a taxable dividend at your marginal tax rate. At the individual level, eligible dividends are taxed at a lower rate than non-eligible dividends. You have to gross-up a dividend payment by an additional 38% (if eligible) or 16% (if ineligible) to arrive at the taxable amount that is included in your income. For example, if you receive an actual dividend of $1,000, you will need to include $1,380 or $1,160 of income on your tax return depending on the type of dividend you receive. Due to this gross-up, the amount of the taxable dividends may have a bigger impact on your eligibility for certain income-tested benefits, such as the Old Age Security.

For federal tax purposes, dividends are eligible for a non-refundable dividend tax credit of approximately 15% (if eligible) or 10% (if ineligible) on the grossed-up dividend amount. This dividend tax credit is meant to reflect the corporate taxes already paid on this income prior to distribution. There is also a provincial/territorial dividend tax credit available, which differs for each province/territory.

### Integration

The purpose of the gross-up and tax credit rules for dividends is to achieve what is commonly referred to as "integration", an important Canadian tax system principle. When a tax system is perfectly integrated, an individual should pay the same amount of tax regardless of whether the income is earned personally or through a corporation.

Therefore, the dividend tax system provides recognition of the taxes already paid by the corporation and alters the personal tax rates for the eligible and ineligible dividends accordingly.

Under the current tax rates, integration is not quite perfect. There is currently an advantage or disadvantage to earning business income in a corporation and then paying out a dividend to the shareholder. Whether there is an advantage or disadvantage depends on whether the business income was taxed at the small business rate or at the general rate as well as your province or territory of residence. Let us look at a simple example that illustrates the concept of integration.

## Integration example

You own a CCPC that operates a successful restaurant business which specializes in seafood dishes. 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.

When a tax system is perfectly integrated, an individual should pay the same amount of tax regardless of whether the income is earned personally or through a corporation.

Let us assume that the combined federal and provincial/territorial small business rate is 15% and the combined general corporate rate is 30%. Let us also assume that you are taxed at a top personal marginal tax rate of 50% on regular income, 35% on eligible dividends and 42% on non-eligible dividends. Based on these assumed rates, when income earned in your CCPC is distributed to you as a dividend, the calculated combined corporate and personal tax rates on ABI up to $500,000 and ABI greater than $500,000 would be 50.70% and 54.50%, respectively. All of these rates are shown in the following table for comparative purposes:

| | 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% | 42.00% | – | 50.70% | 50.00% |
| **ABI > $500K** | 30.00% | – | 35.00% | 54.50% | 50.00% |

In this example, if you need to withdraw funds from your corporation, it may be more advantageous to pay yourself a salary as opposed to dividends, whether or not your corporation is earning less or more than the small business limit. In most provinces and territories the relationship illustrated in the table above exists. Ask an RBC advisor for the tax tables titled “Corporate, Integrated and Personal Tax Rates on ABI” for the integrated rate tables for each province or territory. In addition to the integrated rate, you should take into account the payroll taxes that your corporation will incur when paying a salary. A professional tax advisor can help you determine whether it makes sense for you to receive a salary or taxable dividends from your corporation.

## Planning strategies using dividends

### Refundable Dividend Tax on Hand (RDTOH) and the Dividend Refund

The RDTOH is a notional account for private corporations. It keeps track of refundable taxes paid by the corporation on passive investment income held by the CRA. If there is a positive balance in the RDTOH account, the corporation will receive a refund when it pays a taxable dividend to a shareholder (the “dividend refund”). The corporation receives a dividend refund at a rate of 38 ⅓% of the taxable dividends it pays. The dividend refund is limited to the balance in the RDTOH account.

If your company has an RDTOH balance and you have a low marginal tax rate in the current year, consider paying yourself a dividend up to the point where your marginal tax rate on the dividend reaches the dividend refund rate in the corporation of 38 ⅓%. This strategy will provide you and your corporation with more cash flow overall, since the dividend refund to your corporation will be more than your personal tax on the dividend you received.

For tax years beginning prior to 2019, if there is a positive RDTOH balance, a corporation can receive a dividend refund upon the payment of any taxable dividend. This allows a corporation to receive a dividend refund upon the payment of a preferentially taxed eligible dividend out of income that was not subject to refundable taxes, such as ABI taxed at the general corporate rate, where the corporation’s RDTOH was generated from investment income that would normally need

to be paid out as a non-eligible dividend. This benefit was perceived by the government as an unfair tax deferral advantage.

To address this issue, for tax years beginning after 2018, a private corporation will generally only receive a dividend refund on the payment of non-eligible dividends. An exception will be provided where the RDTOH arises from eligible dividends received by the corporation on portfolio investments. In this case, the corporation will still be able to obtain a dividend refund upon the payment of eligible dividends.

The existing RDTOH account will now be referred to as the "non-eligible RDTOH" account and will track refundable taxes paid on passive investment income (excluding eligible dividends received by the corporation). This account will also track non-eligible dividends received from non-connected corporations. A corporation will only be able to obtain a refund from the non-eligible RDTOH account upon the payment of a non-eligible dividend.

A new RDTOH account known as the "eligible RDTOH" account will be introduced to track refundable taxes paid on eligible portfolio dividends. Any taxable dividend (eligible or non-eligible) paid by a corporation will entitle the corporation to a refund from its eligible RDTOH account. However, an ordering rule requires that a private corporation paying a non-eligible dividend must exhaust its non-eligible RDTOH account before claiming a refund from its eligible RDTOH account.

### Dividend sprinkling

A common income splitting strategy that has often been employed by high income business owners or incorporated professionals to reduce the overall taxes paid on income earned inside a corporation is to pay dividends to lower income family members who are shareholders. This income-splitting strategy is sometimes referred to as "dividend sprinkling."

Dividends paid to minor children from private corporations are subject to tax on split income ("TOSI"), commonly referred to as "kiddie tax". The TOSI rules limit splitting certain types of income with minor children, such as dividends paid from private corporations. Where TOSI applies, the income is taxed at the highest marginal tax rate and the person receiving the income loses the ability to claim personal tax credits on split income, such as the basic personal tax credit.

Beginning in 2018, the TOSI rules have been expanded to include other family members, such as your spouse and adult children, who receive certain amounts directly or indirectly from a related business. A related business is one where a person is related to an individual who

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is either actively engaged in the business, or owns a significant portion of the equity in the corporation that carries on the business. The amounts subject to TOSI, known as "split income", have also been expanded. Although they do not include salaries paid by the related business, they could include interest or dividends, as well as certain capital gains.

As a result of these changes, the ability to sprinkle income among certain family members to reduce taxes payable has been curtailed.

There are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults age 18 to 24, and adults age 25 and over. There is also an exclusion available to the spouse of a business owner who is age 65 or older. The exclusions mainly rely on whether the family member is significantly involved in the business or owns a certain portion of the votes and value of the corporation's shares. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask an RBC advisor for our article discussing income splitting through private corporations.

If you intend to restructure your corporation in order to enable you to pay dividends to family members, watch out for the corporate attribution rules. Corporate attribution will generally apply 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. In general, a company will qualify as a small business corporation where 90% or more of its assets are used in an active business carried on in Canada.

Dividend sprinkling requires that the dividend be paid or made payable to your family members. The implication of this is that the funds will not legally belong to you or your corporation anymore. Therefore, in implementing this strategy, it should be your intention for your family members to have these funds.

Given the recent tax changes that may impact this strategy, you should get both legal and tax professionals involved to ensure that income splitting through your corporation is right for you.

### Providing a shareholder loan

You may be asking, if I need to access money from my corporation, why not simply borrow it from my corporation? The Income Tax Act (ITA) contains very specific rules limiting the ability of a shareholder to borrow funds from their corporation. The general rule is that 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, 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 repay that loan by December 31 of Year 2 to avoid the income inclusion on your personal tax return for Year 1.

In situations where you are subject to the income inclusion, you will receive 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 would not avoid the income inclusion rule.

There are a few exceptions to the income inclusion rules where the loan is made to you in your capacity as an employee and not as a shareholder. The first exception 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 used for very specific purposes: the purchase of a home, the purchase of a car for use in carrying out the duties of employment, and the purchase of treasury shares of the corporation. In order to qualify for an exception, at the time the loan is made, there must be a bona fide arrangement to have the loan repaid within a reasonable time.

Even if you meet these 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.

It is important to note that pursuant to the new TOSI rules mentioned previously, in certain circumstances, a shareholder loan may be considered to be split income that could be subject to TOSI. Given the complexity of the shareholder loan rules as well as the new TOSI rules, it is important that you speak with a qualified tax advisor if you wish to borrow from your corporation.

#### Using corporate assets as collateral

Let's say instead of borrowing money from your corporation, you borrow money from a third party, such as a financial institution. As part of the lending arrangement, the third party requires you to have your corporation guarantee the loan and/or to provide security as collateral for your personal loan. In an arrangement like this, your personal loan from a third party may be deemed under the ITA to be a loan made directly from your corporation to you as the shareholder, causing an income inclusion for you. The amount of the income inclusion is equal to the lesser of the amount of your personal loan from the third party, and the total fair market value of the collateral provided by your corporation. This is as a result of new rules introduced in the 2016 Federal Budget which apply to shareholder loan arrangements as of March 22, 2016. For lending arrangements that existed before this date, the rules deem the shareholder loan to have become owing on March 22, 2016.

There are other situations where these new rules may apply that are not discussed in this article. Speak to a qualified tax advisor if you are considering a personal loan where the lending arrangement with the financial institution may involve your corporation.

If your personal loan from the third party is repaid by the end of your corporation's taxation year following the year you borrowed the funds then the income inclusion will be avoided. For example, if your corporation has a September 30th year-end and you borrow funds in July of Year 1 then to avoid the income inclusion the loan from the third party must be repaid by September 30th of Year 2.

If you had to include the amount of your personal loan in your income in the year you borrowed the funds, you may be able to claim a deduction on your personal return in the year any of the following events occur:

- you repay all or a portion of the amount owing on your personal debt to the third party;
- there is a decrease in the fair market value of the property provided as collateral by your corporation; or
- the collateral arrangement is extinguished.

Before agreeing to a lending arrangement as just described, you should consult with a qualified tax and/or legal advisor.

## Tax-free withdrawals

### Paying a capital dividend

The CDA is a notional account for private corporations. It keeps tracks of the non-taxable portion of capital gains

and the non-allowable portion of capital losses as well as other amounts such as capital dividends received or paid by the corporation and certain life insurance proceeds received in excess of the policy's adjusted cost base. It is intended that the tax-free character of these amounts be transferable to shareholders. As such, when there is a positive balance in the CDA, a tax-free capital dividend can be paid to the company's shareholders. Once a capital dividend is distributed, the CDA is reduced by the amount of the capital dividend paid.

The CDA does not appear on your company's financial statements, nor does it have to be disclosed anywhere. However, you should maintain an annual balance of the account and closely monitor it to allow you to take advantage of any tax-free capital dividends. As a planning strategy, since the non-allowable portion of capital losses immediately reduce the CDA, it may be beneficial to pay a capital dividend when the CDA is positive so that the opportunity is not lost in cases where the corporation realizes a capital loss in the future.

### Reducing paid-up capital

The PUC of your shares represents the consideration your corporation received in return for the shares it issued. For example, upon creating your corporation, if you contributed $20,000 worth of assets to your corporation, you could receive shares with a PUC of $20,000.

In some cases, your corporation can return the PUC to you tax-free as return of capital. You may want to do this in the case where your corporation no longer needs the funds for its operations. The rationale for this tax-free return is that PUC was contributed from your personal after-tax funds on the initial investment in corporate shares. Therefore, the PUC should not be taxable to you on its return.

The determination of PUC for tax purposes can be complicated. In addition, reducing the PUC of the corporation and paying out a tax-free amount may have other negative tax consequences. Consequently, you should consult with a qualified tax professional to determine if reducing the PUC is an appropriate method of withdrawing cash from your corporation in your particular circumstances.

### Repaying loans to shareholders

Unlike the issues surrounding shareholders borrowing from their corporation, there are no similar issues in shareholders loaning money to their corporations. Therefore, you may have chosen to finance your corporation in this manner. Perhaps your corporation owes you money because you transferred personal assets to it by way of loan and received no cash or shares in return. Or perhaps your company declared a dividend or a bonus and you loaned the funds back to your corporation. No matter the reason, when your corporation repays a loan to you, the repayment is not taxable. It is important to note that if a loan is repaid to you by an in-kind transfer of assets, your corporation is deemed to have disposed of the assets at fair market value, resulting a capital gain or loss. Generally the capital loss may be denied. The fair market value of those assets on the date of transfer becomes your new adjusted cost base going forward.

Determining the most appropriate method or combination of methods to withdraw surplus cash from your corporation should depend on your facts and circumstances as well as your corporation's financial position. The decision involves an understanding of your general corporate tax structure, your corporation's tax attributes as well as your personal tax situation.

### Reimbursing shareholders for business expenses paid

If you personally paid for expenses that were incurred by your corporation, for example entertaining clients, your company can reimburse you for those expenses. It is important to keep accurate records and receipts of these expenses paid. When you use your after-tax dollars to pay for business expenses, you do not have to pay income tax on the amounts reimbursed to you by your corporation. In some cases, your company will receive a tax deduction for the business expense.

## Conclusion

Determining the most appropriate method or combination of methods to withdraw surplus cash from your corporation should depend on your facts and circumstances as well as your corporation's financial position. The decision involves an understanding of your general corporate tax structure, your corporation's tax attributes as well as your personal tax situation. Further, both tax and non-tax factors should be considered. Speak with a qualified tax advisor to ensure that all of the relevant factors are taken into consideration prior to making a withdrawal from your corporation.

*This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that*

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