



# Owner/manager remuneration, Part 1

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## Introduction

When accountants talk about owner/manager remuneration of a small/medium business enterprise, most look at the area of salary versus dividends and bonuses to bring corporate income into the low tax rate. However, there is much more to this subject than just those points. Our job as an accountant, whether in public practice or as a controller, is to legally put the most of our client's/boss' hard earned money into their pockets. This series of articles looks at some of the less obvious methods of remunerating the owner/manager, as well as some of the traps into which you can inadvertently fall if you are not careful. By the time you have finished reading this series, you will at least have an understanding of what you can do to accomplish that goal.

### Introduction

### Problems tax planning for the owner/manager

### Forms of remuneration for the owner/manager

### Salaries, bonuses, and management fees

## Problems tax planning for the owner/manager

A major problem in tax planning for the owner/manager is trying to convince that person to consult with their accountant before doing anything. Clients often inform their accountant after the fact that they have done something and then expect us to fix it so they do not suffer any negative tax consequences. Retroactive tax planning is both dangerous and frequently impossible. The "solution" that we come up with is generally not nearly as effective as it may have been had the client consulted with us beforehand. As such, a large part of our job as accountants is to convince our clients that by consulting with us first, we may be able to save them from the grasp of the taxman.

Another problem is convincing the owner/manager that the company is a separate entity. Clients regard the company and themselves as one, and think nothing of using corporate funds to pay for personal items. Using corporate funds for personal use can have disastrous consequences, as we will see. Effective tax planning is virtually impossible in these types of situations.

The owner/manager also presents a unique problem in that they are not only employees, but also shareholders. In some cases, whether certain types of remuneration are received as a shareholder or as an employee will have a bearing on the tax treatment.

## Forms of remuneration for the owner/manager

The owner/manager can receive remuneration in a number of ways. The most common is by way of salary or dividends, but other forms of remuneration include:

- Management fees
- Bonuses

- Loans from the corporation
- Automobile use
- Entertainment and club dues
- Death benefits
- Retirement allowances
- Deferred income plans

We will look at the good, the bad, and the ugly of the foregoing.

## Salaries, bonuses, and management fees

Salaries, bonuses, and management fees are the most common methods of remunerating the owner/manager. Some owner/managers set themselves up on a regular payroll along with the rest of their employees, while others wait until the corporate year end to determine their salary. Draws throughout the year are charged to shareholder's loans. Salaries are usually based on the earnings of the corporation and with an eye to keeping the corporation's taxable income inside the small business limit. In addition, where the owner/manager has taken draws against their shareholder's loan throughout the year, the amount of the draws in excess of shareholder's loans will have to be considered in determining remuneration. Salaries and wages may also be paid to family members, provided that such wages are reasonable. By paying salaries to family members, income taxes can be reduced. There is an old truism that says two people each making \$50,000 pays a lot less tax than one person earning \$100,000.

Bonuses are usually declared on the basis of corporate earnings, mostly in an effort to reduce taxable income, so they are taxed at a low rate. In order to be acceptable to Canada Customs and Revenue Agency (CCRA), there should be a corporate resolution declaring the bonus. This can present a minor problem because the resolution is often overlooked. However, if the company has a practice of declaring bonuses at the year end, the courts have ruled that a resolution is not really necessary. CCRA has accepted that position and has stated that bonuses will be accepted if:

- a) the general practice of the corporation is to distribute the profits of the company to its shareholder-managers in the form of bonuses or additional salaries; or*
- b) the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are, in fact, attributable to the special know-how, connections, or entrepreneurial skills of the shareholders.*

This position applies only to bonuses declared to shareholders/managers who are active in the corporation. Bonuses to non-active shareholders could be challenged if considered unreasonable by CCRA.

However, where bonuses are accrued at the end of a fiscal year, it must be an enforceable liability. Payments contingent on funds being available will be considered as a reserve. Paragraph 18(1)(e) of the *Tax Act* prohibits the deduction of a reserve or contingent amount in most circumstances. CCRA provides meager assistance in determining what it regards as a reserve or contingent liability in paragraph 15(e) of Interpretation Bulletin 109R2:

*... In order for an expense that remains unpaid at the end of a taxation year to be deductible for tax purposes, it must constitute a genuine liability of the taxpayer. If such an unpaid amount does not constitute a genuine liability, no deduction is allowed. For a genuine liability to exist, there must be an enforceable claim by the creditor with a reasonable expectation that the debt will in fact be paid by the debtor. ...*

What constitutes a genuine liability was outlined best in the Tax Court of Canada decision in *Samuel F. Investments Limited v M.N.R.* (88 DTC 1106). The court provided the following analysis:

*... a liability is contingent if the terms of its creation include uncertainty in respect of any of these three things:*

- 1) *whether the payment will be made;*
- 2) *the amount payable; or*
- 3) *the time by which payment shall be made.*

*If there is certainty regarding the three matters just enumerated and time of payment is deferred it will still be a real liability, but in the nature of a future obligation.*

In addition to the foregoing, subsection 78(4) requires payment of accrued bonuses to be made within 180 days — not six months — of the fiscal year end of the corporation. A large number of small businesses do not actually pay out the amount of a shareholder's bonus; rather the amount is transferred to the shareholder's loan of the recipient. When this happens, CCRA has accepted that payment of the applicable withholdings when the next payroll remittance is required will be evidence of payment of the bonus.

Management fees are used in situations where a holding company has been placed between the shareholder and an operating company. In the "old" days, professionals, who were not allowed to incorporate, often set up management companies in order to get a portion of their income taxed at low corporate rates. The tax department quickly recognized the potential for abuse in these management companies and laid out guidelines for these arrangements. These guidelines are still with us today and apply to holding companies, as well as non-arm's length management companies. In order to be deductible, the amount of management fees must be reasonable in relation to the services performed by the company. Bonuses paid by the operating company, to either the management company or directly to an employee, will not be deductible. These rules somewhat limit the use of management fees. Another situation in which management fees may be useful is where there are sister corporations; one with accumulated losses and one that is successful. Provided they are reasonable, management fees could be paid from the successful corporation to the loss corporation, thus utilizing the losses of the one corporation to reduce the income of the other. Again, the payments must be reasonable. The downfall is when the owner/manager collects a salary from the successful corporation and management fees are also paid to the loss corporation. The question then is what exactly does the loss corporation manage? If utilizing this form of management fees, the owner/manager should be on the payroll of the loss corporation.

In order for any expense to be deductible for income purposes, it must be laid out to produce income from either a business or property. In addition, subsection 67(1) states:

*In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was **reasonable in the circumstances.** (emphasis added)*

Reasonableness of expenses has been an ongoing source of conflict with the tax department since the word first appeared in the *Income Tax Act*. When it comes to owner/manager compensation, reasonableness plays a significant part in determining deductibility. CCRA has consistently stated that it will not challenge the reasonableness of salaries and bonuses paid to an active owner/manager. However, Information Circular 88-2, for example, paragraph 18 states:

#### **18. Facts**

*A Canadian-controlled private corporation pays its shareholder/manager an amount as salary that will reduce the corporation's income to its business limit*

*for the taxation year. The amount of the salary is, however, not in excess of a reasonable amount.*

***Interpretation***

*Subsection 245(2), General anti-avoidance rules, would not apply to the payment as the Act recognizes the deductibility of reasonable business expenses.*

As can be seen by this paragraph, CCRA still uses the word “reasonable” in stating its position. The question arises as to what CCRA would consider reasonable as a salary for an owner/manager. In my experience, CCRA has never challenged the reasonability of such salaries. In any event, I doubt that the courts would uphold such a challenge. What right does CCRA have to determine what a person can pay himself or herself and deduct the amount? In this day and age of professional athletes earnings millions per year, top government bureaucrats earning in the hundreds of thousands, and CEOs of large corporations earning millions, who has a right to tell the small business person what they can or cannot pay themselves for the results of their own labour? I believe such a challenge would be considered unconstitutional and be thrown out of court.

On many occasions, payments to family members and non-active shareholders have been successfully challenged by CCRA. This is an area that has been heavily abused over the years, and CCRA has adopted a hardnosed attitude to it. In order to be deductible, salaries and wages paid to a family member must be commensurate with what would be paid to an arm’s length person doing the same job. A minor exception is made for spouses on the basis of the fact that they may be privy to more information than an arm’s length employee and therefore be able to offer more insight into the operations of the company. Unfortunately, salaries to spouses and children often have had more to do with how much tax would be saved than with what duties, if any, were actually performed. As can be imagined, the courts have been somewhat active in this area. For example, in *Maduke Foods Ltd. v Her Majesty the Queen; (1989[2] CTC 284; 1989 DTC 5458)*, the Federal Court – Trial Division found that salaries paid to the spouse and four children of a shareholder were “completely out of proportion to what others receive for working in the store.” In that case, the taxpayer operated a supermarket in Leduc, Alberta. The spouse and children in question lived in Toronto and worked in the store only during the summer months. They were paid salaries ranging from \$8,500 for the children to \$50,000 for the spouse during the years 1982 to 1985. In *Cousins et al v the Queen; (96-4864(IT)I; 96-4865(IT)I; 96-4866(IT)I 1998 [1] CTC 3278)*, the Tax Court of Canada found that salaries paid to the children of the shareholders, which approximated their basic personal deductions, were unreasonable given the children’s ages. In that case, the children’s salaries were determined at the year end. The cheques were made out to the children, endorsed back to the parents, who then deposited them in the company’s bank account as loans from shareholders. The children were not paid on the same basis as other employees, and no record was kept of their hours worked.

The disallowance of salaries and bonuses produces a double-edged sword thanks to the provisions of subsections 15(1) and 56(2). While the company is unable to claim the deduction, those to whom the amounts were paid will still be taxed on the amount received. In the case of salaries to minor children, the parents can be found to have appropriated funds from the company and be taxed on the amounts paid to the children. In situations where the company is in the top tax bracket and the individuals are as well, the tax may well exceed the amount of expense disallowed.

Payment of salaries and wages to non-active shareholders is also subject to the same reasonableness rules. At the 1981 Canadian Tax Foundation Tax Conference, during the round table, Revenue Canada was asked the following:

## **Reasonableness of salaries or bonuses**

1. Can Revenue Canada provide guidelines with respect to the “reasonableness” of salaries paid to employees-shareholders where a private company earns substantially all its income from property?
2. We have seen a situation where an inactive or partially inactive shareholder has had his remuneration questioned as to its reasonableness. In this case, it was “suggested” that salary/bonus in excess of \$25,000 in a year may be unreasonable. Could you please comment?
3. Large bonuses are often paid in order to reduce the taxable income of a CCPC to \$150,000, the small business limit in 1981. These bonuses are then reviewed in the light of section 67. Could you please comment?

## **Department’s position**

1. No specific guidelines have been established to determine the reasonableness of salaries paid to employees-shareholders where a private company earns substantially all its income from property. The amount, if any, which is considered to be reasonable must be based on the facts of each particular case.

In general, when determining whether salaries paid to employees-shareholders are reasonable, comparisons with like services performed in the same or similar businesses are required. In making this evaluation the following information is usually obtained:

- a) the duties performed by the employee and the time expended in carrying out these duties;
  - b) the remuneration of other employees of the same business who have similar types of responsibilities, experience, and skills; and
  - c) the remuneration paid by other businesses of a similar size to employees who render services corresponding to those of the employee concerned.
2. The determination of a reasonable amount for salaries paid to employees-shareholders must be based on the facts of each particular case. Generally, the services performed by an inactive or partially inactive shareholder are substantially less than the services performed by a shareholder involved in the day-to-day operations of an active business and, therefore, the value of the services would be substantially less. It would not be considered reasonable for a shareholder who provides no services to the corporation in which he holds shares to receive a salary.
  3. Subject to the bounds of reasonableness with respect to both the level of salary and bonuses for services performed and the rate of return on investment in shares, the Department generally accepts that a principal shareholder-manager is entitled to determine a mix of salary and dividend that he considers appropriate. Where there is more than one principal shareholder-manager, the creation of separate classes of shares solely to achieve dividend flexibility would usually lead to a presumption of artificiality.

In general, the Department will not challenge the reasonableness of salaries and bonuses paid to the principal shareholders-managers of a corporation when:

- a) the general practice of the corporation is to distribute the profits of the company to its shareholders-managers in the form of bonuses or additional salaries; or
- b) the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are, in fact, attributable to the special know-how, connections, or entrepreneurial skills of the shareholders.

Bonuses paid to shareholders other than the principal shareholders-managers will be subject to the normal test of reasonableness that is set out in a) above.

In the next two articles, we will look at other methods of remunerating the owner/manager, such as dividends, housing loans, automobiles, etc. We will also look at the dangers involved if these are not carefully handled.

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