Owner/manager remuneration, Part 2

By DON GOODISON, CFP, FCGA

Introduction

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In Part I of this series, we looked at remunerating the owners/managers of small/medium business enterprises by way of salaries, bonuses, and management fees. In this document, we will look at dividends and how they may be used to remunerate the owner/manager in a tax effective manner. We will compare dividends and salaries and take a look at the possibility of splitting income with family members through the use of dividends.

What are dividends?

Dividends are a distribution of the after-tax profits of a corporation. Section 248 of the *Income Tax Act* defines dividends as follows: *"dividend" includes a stock dividend (other than a stock dividend that is paid to a corporation or to a mutual fund trust by a non-resident corporation).* Webster's dictionary defines dividend as: *"the share of profits paid to the holders of stocks.*"

While these two definitions are rather uninspiring, dividends are a very powerful tool in tax planning for the owner/manager.

Taxation advantages of dividends as remuneration

Dividends received by an individual are taxed at a much lower rate than wages. For example, a $1,000 dividend received by an individual in the top tax bracket will result in $94 less tax at the federal level than $1,000 of salary. This is the result of the combination of the gross-up of 25% of the dividend and the dividend tax credit, which reduces both federal and provincial taxes. For example, an individual who receives $1,000 in dividend income is required to add 25% to that amount when reporting it on his or her income tax return. However, federal taxes will be reduced by 16.6667% when calculating taxes. When provincial taxes are taken into the calculation, dividends are a tax effective method of receiving remuneration. A person who has no other income can earn approximately $29,000 of dividend income and pay no tax, depending on the province or territory of residence.

Dividends are also taxed lower than interest when received by an individual. Depending on provincial tax rates, $800 of dividend income will yield approximately the same after-tax income as $1,000 of interest income.

McClurg and Neuman and their contribution to the value of dividends

In addition to being taxed at lower rates, dividends provide an easier method of income splitting with a spouse. For example, in Part I of this series, we saw the dangers inherent in paying wages to family members. The wages must be reasonable in relation to the duties

performed by the recipient. Dividends — with exception of those paid to minor children — do not carry such restrictions, thanks to the decisions of the Supreme Court of Canada in two cases: *Her Majesty the Queen, Appellant and Jim A. McClurg, Respondent (1991 [1] CTC 169; 1991 DTC 5001)* and *Melville Neuman, Appellant v. Her Majesty The Queen, Respondent (*1998 *[3] CTC 177; 1998 DTC 6297; 1998 ETC 2065).* In both cases, the taxpayers' wives held a different class of shares than their husbands. The wives were paid dividends on their shares, but the husbands did not receive dividends on theirs. The Tax Department considered this to be a tax avoidance scheme, and assessed the husbands on an equal amount of dividend income under subsection 56(2) of the *Income Tax Act*. Both husbands challenged the assessments in court, eventually reaching the Supreme Court of Canada. In *McLurg,* which was heard first, the Court held that dividends were paid on profits and shares, and could be "sprinkled" to shareholders of different classes of shares. However, Justice Dickson made a comment that the decision may have been different had Mrs. McLurg not been very active in the corporation. The government took this comment to heart and went after Mr. Neuman, whose wife was not active in the company at all. This time, the Supreme Court of Canada left no doubt that it was quite all right to pay dividends to one class of shares to the exclusion of another class, when it stated:

> *s. 56(2) does not apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings. The declaration of a dividend therefore cannot be said to be a diversion of a benefit which the taxpayer otherwise would have received. Such an entitlement requirement is consistent with the purpose of s. 56(2), which is to capture and attribute to the reassessed taxpayer receipts, which he or she otherwise would have obtained. Unless a reassessed taxpayer had a preexisting entitlement to the dividend income paid to the shareholder of a corporation … and consequently s. 56(2) cannot operate to attribute the dividend income to that taxpayer for income tax purposes.*

While the McClurg and Neuman cases dealt with dividends paid to spouses, there were wider implications. Dividends could be "sprinkled" to any *shareholder*, not only to a spouse. This enhanced the use of dividends in splitting income with other members of a family, particularly children. As noted above, dividend income of approximately $29,000 (depending on the province or territory) with no other income will be tax-free. Over the years, that amount has increased from $23,000. A family with four children could shelter approximately $100,000 of income from tax. The most common method of splitting dividend income with children was through the mechanism of a Family Trust. The trust held shares in an operating company owned by the parent(s), with the children as beneficiaries of the trust. Dividends were paid to the trust by the company and passed on to the children.

Needless to say, the government did not like this tax loophole, and went about challenging it. The Courts were not sympathetic to the government, so the government decided to change the law. The year 2000 saw the imposition of the so-called "kiddie tax." The new section 120.4 of the *Income Tax Act* imposes a new tax on certain dividends received by a child under the age of 18. The dividend is subject to tax at the maximum federal rate of 29%, and no credits are allowed against the tax except for the dividend tax credit. The tax applies to the following types of income:

As indicated, the tax on "split income" that is defined in ITA 120.4 includes the following:

(a) taxable dividends from private companies received directly, or through a trust or partnership;
(b) shareholder benefits under ITA 15 received from a private corporation; and
(c) income from a partnership or trust if the income is derived from the provision of goods or services to a business:
- *carried on by a person related to the individual,*

- *carried on by a corporation of which a person related to the individual is a specified shareholder (i.e., owns 10 percent or more of the shares), or*
- *carried on by a professional corporation of which a person related to the individual is a shareholder.*

While the kiddie tax all but shut down using dividends to split income with minor children, dividends can still be an effective method of splitting income with children over the age of 18.

Dividends do have a down side to them. They are not included in the definition of "earned income," and are not considered when determining eligible contributions to a Registered Retirement Savings Plan. As well, they do not qualify as earnings when determining future Canada Pension Plan eligibility. Because dividends are a distribution of after-tax profits of a corporation, they are not deductible by the corporation. Dividends, therefore, should not be considered unless, or until, a corporation's taxable active business income is less than the small business deduction limit. Paying dividends in those circumstances could result in combined corporate and personal tax of approximately 57%, as opposed to about 40% on wages alone. The rule of thumb, therefore, is to pay sufficient salaries to bring the corporation's taxable income down to the small business limit before considering dividends.

In addition to the lower personal tax on dividends received by an owner/manager, dividends have a number of other advantages. One of these is to reduce an individual's Cumulative Net Investment Loss (CNIL). A CNIL results from claiming expenses relating to investments in excess of income from investments. The significance of the CNIL is that it reduces the amount of capital gains deduction that an individual may claim. With the repeal of the basic capital gains deduction in 1995, many taxpayers do not think about the CNIL. However, the capital gains deduction on the sale of the shares of a qualified small business still exists, and a CNIL can result in unforeseen tax consequences should an owner dispose of those shares.

Example

Mary Contrary owns all of the shares of Mary's Garden Store Ltd. She paid $100 for them on incorporation, and they are now worth $400,000. In order to reduce taxes over the years, Mary has invested in a number of tax shelters. As a result, she has a CNIL of $75,000. If Mary disposes of her shares in the garden store, the capital gains deduction would be reduced by $75,000 as follows:

Proceeds	$ 400,000
Adjusted cost base	100
Capital gain	$ 399,900
Taxable capital gain	$ 199,950
Less: CNIL	75,000
Taxable gain eligible for capital gains deduction	$ 124,950

In effect, Mary will be paying tax on the "recaptured" tax losses of other years. Since dividends are considered as investment income, had Mary received dividend income from her corporation, her CNIL could have been reduced or eliminated.

Taxable dividends paid to a shareholder trigger a refund of the corporation's refundable dividend tax. Refundable dividend taxes result from two things: Part IV tax paid by a corporation on the receipt of dividends, and the refundable portion of Part I tax paid on investment income. The Part IV tax on dividend income is equal to one-third of the amount of taxable dividends from a Canadian corporation. The refundable portion of Part I tax is equal to 26.67% of the net investment income received by the corporation. The total of these two taxes make up a corporation's Refundable Dividend Tax on Hand (RDTOH). RDTOH is refundable at the rate of $1 for every $3 of *taxable* dividends paid by the corporation. The

combination of dividend refund and the lower tax on dividends in the hands of the individual shareholder can have very positive results.

Example

Jack and Jane Spratt operated a very successful restaurant business. Over the years, the company built up a very large RTDOH account. Jack and Jane are now in their 70s, and the company is no longer engaged in active business. Both Jack and Jane held down other jobs during their active years. As a result, both have incomes from personal pensions and investments, which put them in the top tax bracket. A payment of dividends in the amount of $100,000 each will result in the following:

Corporation	
Dividend paid	$ 200,000
Dividend refund – 1/3 of dividend	$ 66,667
Personal	
Dividend income (combined)	$ 200,000
Taxable	$ 250,000
Total tax on the dividends at top rate *	$ 63,167
Net tax effect	$ (3,500)

* *The tax shown is based on 2003 British Columbia residents. Results will vary depending on the province or territory of residence.*

As can be seen from the above example, the payments of dividends in this case would be relatively tax neutral. It should be pointed out that building up a large RDTOH is not necessarily a good method of tax planning.

Losses incurred by a corporation in the ordinary course of business are called non-capital losses. These losses have in effect a ten-year life span. They can be carried back to apply against taxable income in the immediately preceding three years, and forward for seven years. Where losses are about to expire, payment of dividends — instead of wages to the owner/manager in the year in which the loss will expire — could result in the corporation having taxable income and being able to apply the loss against it.

One of the more common uses of dividends is to "purify" a company. Successful corporations may build up assets that are considered unnecessary to the day-to-day operations of the corporation. If the fair market value of these assets reaches certain levels, the shares of that corporation no longer qualify for the Lifetime Capital Gains Deduction. In order to qualify for the Lifetime Capital Gains Deduction, the shares of a small business corporation must meet the criteria set out in section 110.6 of the *Income Tax Act*, which requires that:

- *The shares can not be owned by anyone other than the individual or a person or partnership related to the individual.*
- *More than 50% of the fair market value of the assets must be used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it throughout the immediately preceding 24 months.*
- *All or substantially all (considered to be 90%) of the fair market value of the assets must be used principally in an active business carried on primarily in Canada at the determination date.*

These requirements penalize successful businesses by insisting that all, or substantially all, of its assets be used in carrying on an active business primarily in Canada. They do not consider that a corporation may build up cash to provide for future expansion, nor do they provide for possible international expansion of a small business. The Courts have dealt with what constitutes assets that are actively used in business, and have come up with a rule of thumb. If

the removal of the asset would have a detrimental effect on the day-to-day operations of the corporation, the asset is considered as being used in the active business. In order to return the corporation to its favoured state, it must be "purified," which involves removing the offending assets from the corporation. Transferring these assets in the form of dividends is one of the most effective methods of purifying a corporation.

Purifying a corporation in a tax effective manner is a fairly complex exercise which can be costly. Frequently, owners/managers will rightfully point out that the market for their shares is virtually zero, because most potential buyers would want to purchase the assets of the corporation rather than the shares. While that is true in many cases, it only anticipates a sale of the business. On death, the owner/manager would be subject to tax on the increase value of the shares, since the government is interested only in collecting tax and not in acquiring a business. If the shares do not qualify for the capital gains deduction, the owner/manager's legacy may be reduced by considerably more than the cost of purifying the corporation.

Don Goodison, CFP, FCGA, has been in public practice since 1968 and is a partner at the Kemp Harvey Group in Vancouver. He has an impressive reputation as a tax specialist, particularity in the area of corporate reorganizations. A highly regarded seminar leader in the area of taxation, he presents several seminars a year to CGA students and members throughout British Columbia. In 2000 Don was awarded a Life Membership by CGA BC.

In his last of three articles, Mr. Goodison discusses some of the more novel ways of remunerating the owner/manager, such as loans and registered pension plans.