



Owner/manager remuneration, Part 3

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In Parts 1 and 2 of this series, we covered the most common forms of owner/manager remuneration: salaries, wages, and dividends. In this article, we will look at several other methods of remunerating the owner/manager; some are fairly common and some are not.

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Non-deductible membership dues

When the Federal Income Tax Act underwent its massive overhaul in 1972, one of the changes that resulted from it was the prohibition of deductions for the use of recreational facilities, such as golf courses and camps. Expenses for the use of a yacht were also prohibited. This was done through the introduction of paragraph 18(1)(l), which states:

In computing the income of a taxpayer from a business or property no deduction shall be made in respect of ...

an outlay or expense made or incurred by the taxpayer after 1971,

- (i) for the use or maintenance of property that is a yacht, a camp, a lodge or a golf course or facility, unless the taxpayer made or incurred the outlay or expense in the ordinary course of the taxpayer's business of providing the property for hire or reward; or*
- (ii) as membership fees or dues (whether initiation fees or otherwise) in any club the main purpose of which is to provide dining, recreational or sporting facilities for its members.*

For whatever reason, the deduction of these expenses was considered an abuse of the tax system. Without belabouring the issue, like any other expense, there are times when expenditures incurred for these “evil” activities are definitely incurred for business purposes and times when they are not. Since 1971, it has been a common practice for many corporations to charge the shareholder’s loan for payments made for these offending expenses when paid on behalf of a shareholder, or as a taxable benefit when paid for an employee. The thinking behind this is that if it is not deductible, it cannot be a company expense. However, just because it is not deductible for tax purposes does not mean that it is not a legitimate corporate expense. It means only that the expense has to be added back to income on the T2S(1) in determining taxable income. This can result in tax savings for the owner/manager and, as a result, more money in his/her pocket. This can be illustrated with the following example:

Example

Taylor Mayde is the owner of a successful small business and an avid golfer. He often entertains customers and potential customers with a round of golf and food at the golf course. The corporation has purchased a membership in a local golf club and pays all the costs relating to the membership. Taylor is charged a personal portion for any non-business use of the membership. The fees are \$5,000 per year. Taylor has taxable income of

\$125,000 before any adjustment for the golf membership, and the corporation has net income of \$186,000 before any adjustment for the golf membership. For purpose of this example, Ontario tax rates for 2003 are used.*

Charged to shareholder and added to salary

Corporation income	\$ 186,000
Add back golf membership	5,000
Less: Additional shareholder salary	<u>(5,000)</u>
Taxable income	<u>\$ 186,000</u>
Corporate taxes payable	<u>\$ 34,633</u>

Personal taxable income	\$ 125,000
Additional salary for golf membership	5,000
Taxable income	<u>\$ 130,000</u>
Personal taxes payable	<u>\$ 44,908</u>
Combined personal and corporate taxes	<u>\$ 79,541</u>

Added back to corporate income

Corporation income	\$ 186,000
Golf membership added back to income	5,000
Taxable income	<u>\$ 191,000</u>
Corporate taxes payable	<u>\$ 35,563</u>

Personal taxable income	<u>\$ 125,000</u>
Personal taxes payable	<u>\$ 42,588</u>
Combined personal and corporate taxes	<u>\$ 78,151</u>

Tax savings by adding to corporate income
\$79,541 – \$78,151 \$ 1,390

** The results will vary depending on the province or territory of residence.*

The decision to add back the expense to corporate income must be taken with caution. Careful documentation of who, when, and where should be kept in order to justify the expenditure as a business expense. If the expense were found to not relate to business, it would be considered an appropriation of corporate funds and added to the individual’s income. As well, it would be denied as a deduction to the corporation. If both the corporation and the individual are in the top tax bracket, combined taxes could exceed the amount of the expenditure. On the other hand, if it can be shown that expenditures such as golf memberships, green fees, social or athletic club memberships, etc. are paid out more for the advantage of the corporation than the individual, no taxable benefit will be charged to the individual.

Studies have shown that employees who are physically fit are more productive than those who are not. In recent years, companies have started providing exercise facilities on their premises for the use of employees. The Canada Customs and Revenue Agency (CCRA) has stated that, if such facilities are available to all employees, any benefit will be non-taxable.

The company car

There are still corporations that provide company-owned automobiles for their shareholders and managers in the belief that they are providing a tax effective benefit to the person. While a company-owned automobile is a tax effective benefit to an employee who is not a shareholder, it is not when the employee is also the owner. An employee who uses a company car for personal use must pay tax on a “standby charge.” The standby charge varies depending on whether the vehicle is leased or owned by the corporation. If the corporation owns the vehicle, the **minimum** standby charge is equal to 2% times the number of 30-day periods in which the vehicle is **available** to the employee times the cost of the vehicle. If it is leased, the

minimum standby charge is equal to two-thirds of the lease cost. To these amounts the corporation must add the operating costs applicable, minus reimbursements by the employee, plus GST on both the standby charge and the operating cost. There is a “relieving provision” (recently amended effective for 2003) whereby the minimum standby charge may be reduced if the vehicle use is primarily for business; i.e., 50% (formerly 90%) and the personal kilometres do not exceed 1667 (formerly 1,000) per month or 20,000 per year. In order for this relieving provision to apply, the employee must meet both tests. A mileage log must be kept in order to support this claim. The auto benefit calculations are quite complex and can be made on a form entitled [Calculating Automobile Benefits for 2003 and Later Taxation Years](#). See Income Tax Interpretation Bulletin IT-63R5 for a good discussion of the technical aspects of these rules.

The words “minimum” and “available” are very important in determining the standby charge. First of all, the “minimum” standby charge is just that. Subject to the foregoing relieving provisions, it does not matter how much or how little an employee uses the vehicle personally, the **minimum** standby charge is what gets added to income. Second of all, the word “available” also means just that. Even if the employee does not use the vehicle, the fact that it is available for use is sufficient to result in a minimum standby charge being assessed. However, for the non-equity manager, a company-owned vehicle does provide a tax effective method of remuneration, as the following example shows.

Example

	Owned Personally	Company Owned
Vehicle cost	\$ 23,250	\$ 23,250
Amount financed	\$ 17,250	N/A
Interest rate from dealer	3.90%	N/A
Number of years financed	5	N/A
Monthly payments	\$ 316.91	N/A
Annual operating costs including insurance	\$ 4,200	\$ 4,200
Personal marginal tax rate	N/A	40.44

Year 1

Down payment	\$ 6,000	N/A
Total monthly payments	\$ 3,803	N/A
Total operating costs	\$ 4,200	\$ 4,200
Minimum standby charge	N/A	\$ 5,580
Total standby charge	N/A	\$ 9,780
Tax at marginal rate	N/A	\$ 3,955
Total employee cash outlay for the year	\$ 14,003	\$ 3,955

The actual cash outlay by the employee for the vehicle is \$10,048 less in the first year if the company owned the vehicle. In years two to five, the savings are \$4,048 per year. In fact, the total savings exceed the cost of the vehicle over the five-year term of the loan. The results are less spectacular if the individual is in a lower tax bracket.

When it comes to the owner/manager situation, the results are not quite as favourable because the combined personal and corporate effect must be considered. This would necessitate the addition of the cost of the vehicle to the first year’s cash outlay by the company, making the net cash outlay in year one \$27,205. Over the five-year period, the total cash outlay would be \$46,015 if owning the vehicle personally, and \$43,025 using the company vehicle.

A major downside to the use of company vehicles relates to the maximum amount allowed for capital cost allowance claims by the corporation. Vehicles costing more than \$34,200 are included in Class 10.1 for capital cost allowance determination. Class 10.1 limits the amount of capital cost allowance to that calculated on \$30,000 plus applicable taxes. Unfortunately,

where Class 10.1 vehicles are made available to employees for personal use, the standby charge is calculated on the actual cost of the vehicle, not on the amount allowed the company for capital cost allowance. Another downside lies in providing an employee with a vehicle that is already owned by the company. The standby charge is based on the original cost of the vehicle, not on the current market value. For example, if a five year old vehicle, with an original cost of \$24,000 and a current fair market value of \$8,000, is given to an employee for personal use, the standby charge will be charged on the \$24,000 original cost, not on the \$8,000 fair market value.

Leased vehicles will produce much the same net result as owned vehicles. However, the courts have ruled that standby charges on used vehicles that are leased must be based on the **original manufacturer's retail price**, not on the current fair market value of the vehicle. It would therefore seem wise to lease new vehicles only if a standby charge may be involved.

The use of automobile allowances may be the most effective manner of getting cash into the hands of the owner/manager where the vehicle is used for business purposes. A reasonable automobile allowance is non-taxable in the hands of the recipient, but is deductible in determining the corporation's taxable income. CCRA provides the following allowances for 2003:

- 42¢ per kilometre for the first 5,000 kilometres;
- 36¢ per kilometre thereafter; and
- an additional 4¢ per kilometre for travel in the Northwest Territories, Yukon, and Nunavut.

Based on this guideline, an owner/manager who drives 10,000 kilometres in a year on business can charge the corporation \$3,900 in automobile allowance.

Automobiles can provide some good possibilities of remunerating the owner/manager. Whether the greatest benefit will come from corporate ownership or personal ownership requires calculation based on the particular circumstances of the situation.

Interest free and other loans

Subsection 15(2) of the *Income Tax Act* requires an individual to include in income the amount of any funds received from a corporation of which they are a shareholder. However, some loans and advances are not required to be included in income, provided certain conditions are met. These are detailed in subsections 15(2.3), 15(2.4), and 15(2.6). The exemptions are as follows:

- Loans made in the ordinary course of the lender's ordinary business of lending money – 15(2.3).
- Loans made to assist the employee in acquiring an owner occupied dwelling – 15(2.4)(b).
- Loans made to assist the employee in acquiring shares of the corporation or a related corporation from treasury – 15(2.4)(c).
- Loans made to assist the employee in acquiring a vehicle to be used in the course of his/her duties – 15(2.4)(d).
- Loans repaid within one year of the end of the lender's fiscal year in which the loan was made.

In all of the above, bona fide repayment terms must be established.

Like any good tax provision, there is a black cloud behind the silver lining. All of the above exemptions deal with loans to employees, not to shareholders. Owner/managers must receive any of the above loans in their capacity of employee, not shareholder. Opinions vary, in situations where the owner/manager is the only employee and only shareholder, as to whether CCRA will accept such loans as being made to an employee and not a shareholder. It is highly recommended that corporate minutes authorizing the loan state that the loan is being

made to an employee. Whether that would pass scrutiny is not clear, but it certainly would not cause any harm.

Interest need not be charged on loans to employees/shareholders. In fact, it is recommended that interest not be charged. If no interest is charged, section 80.4 of the *Income Tax Act* rules that the borrower will be deemed to have received a taxable benefit equal to a prescribed interest rate. The prescribed rate for this purpose is set quarterly by CCRA. The rate used for determining the taxable benefit (with certain exceptions) can never exceed the prescribed rate in effect on the date of the loan, but can be less if the prescribed rate is lowered. For example, the prescribed rate on benefits for the period July 1, 2003 to September 30, 2003 is 4% per annum. The taxable benefit on a loan made in that period will be calculated at 4%. If the rate increases to 5% for the quarter, the benefit will remain at 4%. Should the rate fall to 2% in that quarter, the benefit will be calculated on the lower rate of 2%. In the case of a housing loan, the rate must be adjusted every five years, in line with most commercial mortgages.

If interest is not charged, all payments can be applied to the principal of the loan, either shortening the repayment period or reducing the payment amount. As well, the owner/manager's cash outlay in respect of interest is reduced to the tax on the prescribed rate. For example, a commercial mortgage of \$200,000 with an interest rate of 4.75% and a 25-year repayment requires payments of \$1,135 per month. If no interest were charged, the payment is reduced to \$667 per month. After five years, total payments on the commercial mortgage would be \$68,100. If the owner/manager is in a 44.5% marginal tax rate, the combined total of actual payments plus tax on the prescribed interest rate of 3% is \$52,037. This is an actual cash savings of \$16,063 in the hands of the owner/manager. At the end of five years, the balance on the commercial mortgage would be \$175,622, while the balance remaining on the non-interest loan would be \$160,000.

Section 80.5 of the *Income Tax Act* states that a benefit deemed by section 80.4 to have been received in a taxation year is considered to be interest paid in, and payable in respect of, the year by the debtor pursuant to a legal obligation to pay interest on borrowed money for the purposes of subparagraph 8(1)(j)(i) and paragraph 20(1)(c). Therefore, if the loan was made for the purpose of acquiring an automobile or shares in the corporation or related corporation, or any deductible purpose, the interest benefit could be deductible provided the requirements of subparagraph 8(1)(j)(i) and paragraph 20(1)(c) are otherwise met. If that were to be the case, the net tax effect of the benefit would be zero.

Retiring allowances

Prior to 1996, retiring allowances paid to an employee were eligible to be contributed to a Registered Retirement Savings Plan (RRSP) subject to certain limitations. The eligible amounts were \$2,000 times the number of years the employee was employed by the employer or a person related to the employer plus \$1,500 times the number of years before 1989 in respect of which the employer did not make contributions to a deferred profit-sharing plan or a registered pension plan. Despite the repeal of this provision for years after 1995, it still applies to years prior to 1996. An owner/manager whose employment began in 1980 and who retires in 2003 could receive a minimum retirement allowance eligible for transfer to a RRSP of \$32,000, to a maximum of \$45,500 if no Registered Pension Plan (RPP) or Deferred Profit Sharing Plan (DPSP) contributions were made by the employer.

Deferred income plans

Contributions to deferred income plans by the corporation are another method of remunerating the owner/manager. The types of plans that could be used are:

- Registered Retirement Savings Plans (RRSP);
- Registered Pension Plans (RPP); and
- Deferred Profit Sharing Plans (DPSP).

There are a number of variations within these plans, but the basic concept is to provide retirement income to the owner/manager with the least possible cash outlay. The fact that they are tax subsidized reduces the cost of the plans both to the corporation and to the owner/manager. Employer contributions to RRSPs and DPSPs are taxable benefits to the employee. However, as we have noted, if the only cash outlay the employee has to make is the tax on the benefit, it is substantially cheaper than having to make the contribution personally. Contributions to RRSPs and DPSPs are subject to the prescribed contribution limits for the individual.

RPPs are more complicated depending on whether the plan is a Defined Benefit Plan (DBP) or a Money Purchase Plan (MPP). Both types of plans have their positives and negatives, and can be costly to administer. As well, the DBP could result in serious problems for the corporation if investments do not perform up to expectation. RPPs should be looked at with caution, but not fear.

Conclusion

In this series of three articles, we have looked at a number of methods of remunerating the owner/manager. However, in no way do we claim to have covered every possible method. For example, several benefits that are not included in income by an employee (also active shareholder) that we have not discussed in this series are:

- group sickness or accident insurance plan;
- private health services plan;
- supplementary unemployment benefit plan;
- a retirement compensation arrangement;
- an employee benefit plan or an employee trust;
- counselling services in respect of:
 - (a) the mental or physical health of the taxpayer or an individual related to the taxpayer, other than a benefit attributable to an outlay or expense to which paragraph 18(1)(l) applies, or
 - (b) the re-employment or retirement of the taxpayer, and
- a salary deferral arrangement, except to the extent that the benefit is included in income under paragraph 6(1)(a) because of subsection 6(11).

The above are all worth exploring.

Undoubtedly, there are other methods currently in use or just waiting to be discovered.

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