Canadian Current Tax

VOLUME 28, NUMBER 4 Cited as 28 Can. Current Tax JANUARY 2018

# • YEAR END TAX PLANNING FOR BUSINESS •

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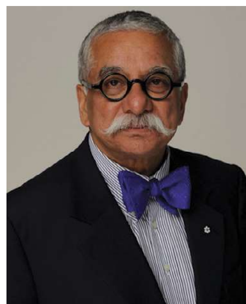

Vern Krishna CM

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**Canadian-controlled** private corporations (CCPCs) that carry on an active business in Canada are taxable at special low rates. In 2017, the first $500,000 of income from such active business income (ABI) is taxable at a combined federal and provincial rate of about 15 per cent. Income above $500,000 is taxable at about 27.5 per cent. Hence, it is important to plan for shareholder and corporate taxation before the year end to maximize rates of return, and minimize the overall tax burden.

Taxpayers who employ their spouse or adult children in their CCPC should pay them salaries if they have a low marginal tax rate. This form of income shifting can reduce the total tax burden on the family, and put money into the hands of children to pay for their education and other expenses. Paying family members a salary also allows them to build up their retirement income through Registered Retirement Savings Plans (RRSPs).

There are, however, several traps to watch for. Any salary must be reasonable and commensurate with the nature of the work that the spouse or children perform. As a general rule, one can pay a salary that is approximately equivalent (or even *slightly* higher than market rates). Since the payment would be within the family, it is advisable to keep meticulous records as the CRA will want cogent evidence for the deductions.

*Canadian Current Tax is published by LexisNexis Canada Inc. in collaboration with the CGA Tax Research Centre. The CGA Tax Research Centre at the University of Ottawa promotes research in Canadian domestic and international tax law through publications, conferences and as a conduit to governmental agencies.*

## CANADIAN CURRENT TAX

**Canadian Current Tax** is published monthly by LexisNexis Canada Inc., 111 Gordon Baker Road, Suite 900, Toronto ON M2H 3R1 by subscription only.

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**ISBN 0-409-91091-0 (print)** **ISSN 0317-6495**
**ISBN 0-433-44637-4 (PDF)**
**ISBN 0-433-44375-8 (print & PDF)**

Subscription rates: $595.00 per year (print or PDF)
$685.00 per year (print & PDF)

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**Publications Mail**
Reg. No. 186031

DIVIDENDS

Where the spouse and children over 18 years of age subscribed for shares in the corporation with their own funds, the corporation can pay them dividends out of its after-tax income. If the spouse and children have a lower marginal rate of tax than the principal shareholder, the dividends will be taxable at a low rate and eligible for the dividend tax credit.

The advantage of paying dividends under the current rules is that they do not need to be reasonable in amount, and the shareholder does not have to work for the income. In corporate law, dividends are a return on investment capital.

A business cannot split income with minor children under the age of 18 because of the special "kiddie tax" rules. Minor children are taxable at the top federal marginal tax rate of 33 per cent on dividends, as well as on certain types of business income.

However, under the guise of "fair taxation", the Liberals plan to upend corporate law, and convert the taxation of private corporation dividends into a form of salary income, which is taxable at a much higher rate. The Liberals also plan to extend the "kiddie tax" rules to children under the age of 25. The details of the new rules have not been released, but we can be quite certain that they will be punitive.

Hence, effective 2018, the door to income shifting through dividend sprinkling will close or, at least, become narrower. The Liberals have announced that they will curtail income shifting to family members in CCPCs. The proposals (there is no legislation to date) call for curtailing dividends to family if they are not working in the business, or have not provided capital, or assumed risk in the business.

A CCPC that pays a dividend may be able to obtain a tax refund on its corporate taxes if it previously earned investment income, and has a balance in its refundable tax on hand (RDTOH). The refund would be claimed on the corporation's tax return. However, the recipient would have to pay tax on the dividend at their personal tax rate. All in all, an individual who receives about $50,000 of dividend income will pay no tax if they have no other source of income.

This can be very helpful in splitting income with spouses, and children attending university.

The good news is that the Liberals have announced that they will lower the federal small business rate to 10 per cent in 2018, and 9 per cent in 2019 (election year). In addition, Ontario has also, coincidentally, announced a 1 per cent rate reduction for CCPCs in 2018 (election year). Hence, a certain amount of income deferral into 2018 will be advantageous.

SALARY AND DIVIDEND MIX

Business people who withdraw funds from their corporation must consider the character of their income before year-end. Each source of income has its own rules, which needs to be considered in tax planning. Generally speaking, an individual should have a mix of dividends and salary income to optimize deductions and retirement planning.

The factors to consider are the applicable corporate tax rate, and the shareholder's personal marginal rates for salary and dividend income. For example, in 2017, a salary of $145,722 will allow the maximum registered retirement savings plan contribution of $26,230 in 2018.

Income that is not characterized either as salary or dividends will be treated as a shareholder loan in many cases. A shareholder loan is taxable without the benefit of the dividend tax credit and, therefore, attracts higher tax. Additionally, the corporation cannot deduct the shareholder loan. Hence, it also pays more tax. A shareholder loan is not considered "earned income" and, as such, cannot be taken into account for the purposes of making RRSP contributions.

It is also important that the business withhold appropriate income tax, Canada Pension Plan contributions and employment insurance as well as any provincial payroll taxes. The business must report all withholdings on T-4 slips.

TAX DEFERRAL

The Liberals have also announced that they will penalize private corporations that earn and retain passive investment income above $50,000. Hence, it would be prudent to start planning for the extraction of surplus investment funds in order to avoid punitive tax rates on such income. Shareholders who have lent money to their corporations might want to start withdrawing such funds in order to control potential passive income above $50,000 in the corporation.

There are no details provided for the intended measures. Ultimately, the Liberals will reveal all, but it is reasonable to expect that what they do reveal will not be pleasant. 2018 is going to be a difficult year for tax planners and their clients. However, 2019 and beyond will be better years for tax litigators, as disputes escalate and trials become longer and more frequent.

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