GLOBAL ASSET MANAGEMENT

Tax, Retirement and Estate Planning

RIGHT ON THE MONEY – OPTIONS FOR EXTRACTING CASH FLOW FROM A CORPORATION

Building a profitable and sustainable business requires time, patience and hard work. In the early years, it's common for owners of Canadian-controlled private corporations (CCPCs) to reinvest income in the business and forgo salaries, dividends or other remuneration. At some point, however, personal living costs require cash flow from the corporation. This leads business owners to ask: what are the options for extracting cash flow from a corporation and which options are best for me?

There are several options for withdrawing cash from a corporation, each with their own pros and cons. The best option(s) normally depend on the circumstances and the short and long-term objectives of the business owner. Are tax-free payments the primary objective? Perhaps creating RRSP contribution room is the goal. Maybe the payment is being made to reduce corporate taxes, or a loan to a shareholder makes sense. Whatever the reason, simply taking money from a corporation's bank account for personal use without properly defining the payment can lead to unexpected tax results.

We've listed common options for withdrawing funds from a corporation and related issues to consider:

Type of payment	Considerations
Salary and bonus payments	▪ Payment must be reasonable for work performed[1] ▪ Fully taxable at employee's marginal tax rate ▪ Employees can include owner-manager, family members or others[2] ▪ Tax-deductible to the corporation which can help reduce taxation at general corporate tax rates ▪ Creates RRSP contribution room ▪ Payroll taxes normally apply (e.g., C/QPP contributions, EI premiums[3]) ▪ Less impact to income-sensitive Old Age Security (OAS) benefits than taxable dividends ▪ Not subject to "tax on split income" (TOSI) – more on TOSI below ▪ Required for IPP and RCA strategies[4]
Taxable dividend	▪ Must be a shareholder to receive dividends, but do not need to work for the business ▪ Taxed more efficiently than salary – tax rate depends on the characteristics of the dividend (i.e., eligible or non-eligible) ▪ Payment is non-deductible to the corporation ▪ TOSI rules stipulate that payments to family members who do not contribute to the business may be subject to taxation at the top marginal rate. ▪ Dividends paid to minors are normally subject to a TOSI resulting in taxation at the top marginal rate. ▪ No payroll taxes (e.g., C/QPP contributions, EI premiums)[5] ▪ Can result in a larger reduction to OAS benefits compared to taking a salary because of the dividend "gross-up" mechanism. ▪ Allows for larger charitable donation tax credit claims than salary because of the dividend "gross-up" mechanism.

Type of payment	Considerations
Capital dividend	▪ Tax-free payment from corporation's notional capital dividend account (CDA) when the account has a positive balance. ▪ Positive CDA balance normally results from realized net capital gains (non-taxable portion) and tax-free life insurance payments (net of adjusted cost base). ▪ Capital dividend payments reduce the corporation's CDA balance. ▪ CDA balance is also reduced by realized capital losses – for this reason, owners may choose to immediately pay capital dividends when available before capital losses are realized.
Repayment of capital	▪ Payments that are less than a corporation's "paid up capital" (PUC) can be paid to shareholders as a "repayment" or "return" of capital (ROC). ▪ ROC payments are tax-free provided PUC is reduced by the amount of the payment. ▪ PUC is essentially capital contributed to a corporation in exchange for its shares, normally when the corporation is established. The amount can change over time with transactions. ▪ ROC payments are non-deductible to the corporation.
Repayment of shareholder loan	▪ Tax-free payment to shareholder in settlement of any outstanding loan to the corporation ▪ Payment is non-deductible to the corporation
Loan to shareholder	▪ Loan amount is fully taxable to shareholder unless the payment is for certain employment purposes[6] or repaid within one year after the end of the corporation's taxation year. ▪ Loan amount is non-deductible to the corporation. ▪ If the loan falls into one of the above exceptions, but is made at a no or low interest rate, a taxable deemed interest benefit applies[7]. ▪ Where the loan is included in the shareholder's income but subsequently repaid, shareholder is allowed a deduction from income for the year of repayment.

[1] A corporation can normally deduct unlimited salary paid to its owner-manager on the principle that its profits are due to the owner's work; [2] Provided amounts paid align with services provided; [3] Employment insurance premiums do not apply for salaries paid to owner-managers who own 40% or more of the voting shares of the corporation; [4] Contributions to Individual Pension Plans and Retirement Compensation Arrangements are normally based on T4 income. [5] No C/QPP contributions mean no related C/QPP retirement benefit; [6] To purchase a home, shares of the corporation or a motor vehicle for employment purposes; [7] Equal to the difference between the CRA's prescribed rate and the rate paid.

Determining an appropriate cash flow mix

Whether you require cash for lifestyle or financial obligations, determining an appropriate cash flow mix can be complicated. Owners are advised to consult their tax advisor to review their corporation's structure and tax attributes, as the best approach can differ from corporation to corporation. When determining an optimal strategy, shareholders should consider the following:

- Is one form of cash flow more costly than another when all taxes (e.g., corporate and personal) are considered?
- Is a corporate tax deduction required to reduce or avoid taxation at general corporate tax rates (as opposed to the small business rate)?
- Are tax-free payment options available?
- Who is receiving the payment and can/should capital dividends be reserved for the owner-manager?
- Is there a desire for RRSP contribution room and/or C/QPP retirement benefits?
- Will the payment trigger payroll taxes and/or onerous remittance or tax filing obligations?
- Is there a plan to establish an IPP or RCA at some point in the future?
- What impact will the payment have on income-sensitive benefits (e.g., OAS)?
- If the payment is for income-splitting purposes, will attribution or punitive TOSI rules apply?

Can't I just take a payment without "formalizing" it?

When personal cash flow needs arise, business owners may be tempted to withdraw money from the corporation without formalizing the payment. Indeed, with solely-owned businesses there wouldn't be anyone to prevent the owner-manager from doing so. However, the Income Tax Act (ITA) has rules in place to discourage such activity, as amounts withdrawn from a corporation are normally subject to personal taxation, with the exception of certain defined options for extracting tax-free cash flow.

Specifically, section 15(1) of the ITA indicates that where a benefit, including cash, is conferred on a shareholder by a corporation, the benefit is included in the shareholder's income for that year. If the benefit is not reported as income, the Canada Revenue Agency (CRA) can reassess, resulting in double taxation and potential gross negligence penalties payable by the shareholder. Consider the following example.

Earlier this year, Angela, owner-manager of ABC Inc., withdrew $10,000 from her corporation's bank account for a personal trip to the Caribbean. No formal declaration of payment was made and Angela has no intention of repaying the amount to the corporation.

As per the ITA, Angela is required to include the $10,000 withdrawal as part of her income for the year. Failure to do so can result in a gross negligence penalty of 50% of the understated tax payable. Making matters worse, while taxable to Angela, the $10,000 withdrawal is not deductible to the corporation, resulting in double taxation.

While "benefit" is not defined in the ITA, it normally includes any type of payment or advantage to a shareholder outside the normal course of business and can include personal use of company assets, such as equipment or vehicles. Given the punitive penalties that can result from shareholder benefits and appropriations – double taxation and gross negligence penalties – these situations should be avoided.

Whether it be for personal leisure or to meet financial obligations, it is important to plan how best to withdraw money from a corporation. The best option(s) for one client might not work well for others, and personal and corporate objectives, both short and long-term, play a role. Business owners are encouraged to work with their tax advisors to determine an appropriate cash flow strategy driven by their specific circumstances.

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