Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Withdrawing surplus cash from a corporation

As a business owner, you may have surplus cash accumulating in your corporation. Is there a business need for the cash? Or do you need the funds personally and wish to withdraw them from your corporation? What's the most tax-efficient way of withdrawing funds? This article discusses various methods of withdrawing cash from your corporation as well as the tax issues and benefits that might apply with each method.

The terms "corporation" and "company" are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that's not controlled by a non-resident of Canada or a public corporation, or a combination of both. In addition, no class of shares of the CCPC can be listed on a prescribed stock exchange. This article does not apply to public corporations or to businesses operating as a partnership or a sole proprietorship.

Any reference to a spouse in this article also includes a common-law partner.

Withdrawing cash from your corporation

If there's no business need for the excess cash within your corporation, consider whether you have a personal need for the funds such as paying for lifestyle expenses or purchasing a vacation property. If you have a personal need for the surplus cash in your corporation, the next step is to determine the best way to withdraw the money, paying special attention to the tax consequences. Some methods of withdrawing cash from your corporation are taxable and some could be tax-free.

Taxable withdrawals

Paying a salary or bonus

At the corporate level

A salary or bonus paid by your corporation is generally considered a deductible expense and will lower your corporation's taxable income.

The level of corporate income will often influence whether your company should pay you a salary or bonus as opposed to an alternative form of compensation. For instance, it may make more sense for your operating company, earning active business income (ABI), to pay you a salary or bonus if it's paying tax at the high general corporate tax rate as opposed to the lower small business rate. This allows your company to get a deduction from their income at a higher corporate tax rate.

There's an additional cost to your corporation in the form of payroll taxes when it pays a salary or bonus. Your corporation has to match an employee's contribution to the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP). You and your corporation may not have to contribute to Canada's Employment Insurance (EI) program where you, as an employee, are also a shareholder.

Salary paid by your corporation may attract other payroll expenses such as provincial workers' compensation and health tax (depending on the province/territory in which your corporation is located and the thresholds in that province/territory).

Reasonableness

In order for a salary or bonus payment to be deductible, the amount paid must be reasonable. For business owners of an operating company, reasonableness is generally not an issue provided you, as the owner-manager, are actively engaged in the operations of the corporation and contribute to the profits earned by the corporation using your special know-how or entrepreneurial skills.

The Canada Revenue Agency (CRA) has given no specific guidelines in determining the reasonableness of salaries or bonuses paid to owner-managers of holding companies that earn substantially all investment income (passive income). The amount, if any, which is considered reasonable must be based on the facts of each particular case. In making this evaluation, the CRA may look at the duties you perform and the time spent to earn the passive income. They may also look at the experience and skills necessary to perform your duties as well as the remuneration paid by other businesses of a similar size to their employees who render similar services.

In any case, since a portion of the tax paid by your corporation on passive income is refundable to the corporation when taxable dividends are paid out to the shareholders, it may make more sense to pay a dividend to recover the refundable taxes. If you're considering paying yourself a salary from your holding company, you should consult with your qualified tax advisor to determine whether doing so makes sense in your circumstances.

Under certain circumstances, you may consider personally borrowing funds (e.g. from a financial institution) to invest in a non-registered portfolio outside of your corporation to increase your wealth.

At the individual level

The gross amount of your salary or bonus (before source deductions) is employment income and is subject to tax at your marginal tax rate in the year it's received.

Planning strategies using a salary or bonus

Income splitting

If your spouse and children participate in the business, consider paying them a reasonable salary for services rendered. Your corporation may be entitled to a deduction for the salary paid and your family members will include the salary in their income. This is an income-splitting strategy that may reduce your family's overall tax bill if your spouse or children are in a lower tax bracket than you. Further, the salary income will be considered earned income and help your family members generate RRSP contribution room. Please note that if the salary is not considered reasonable, your corporation will not be entitled to a deduction for the salary paid while your family members will still be required to include it in their income, resulting in double taxation.

Borrowing to invest

Under certain circumstances, you may consider personally borrowing funds (e.g. from a financial institution) to invest in a non-registered portfolio outside of your corporation to increase your wealth. This is generally a long-term strategy that may not be effective if you need the funds in the short- to medium-term.

If you're borrowing money to invest in income-producing assets, the interest paid on your borrowings may be tax-deductible to you. You'd need to pay yourself a salary at least equal to the interest cost of your borrowings. Your corporation would be entitled to deduct the salary paid and you'd have an income inclusion personally that's offset by the interest deduction related to the borrowings. With this strategy, over the long-term, you'll be able to continue withdrawing funds from your corporation in a tax-efficient manner and your non-registered portfolio of investments will hopefully grow in value. Please note that if you live in Quebec, the provincial tax laws limit the interest you may deduct in any given year to the investment income you earn in that year, so this strategy may not be as effective.

Using borrowed money to finance the purchase of securities involves greater risk than using your existing resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by the terms of the loan remains the same even if the value of the securities purchased declines. Before implementing this strategy, it's important to understand the concept of borrowing to invest and all the related risks. Speak with a qualified tax advisor to determine if this strategy is suitable for you.

Paying a taxable dividend

You can withdraw funds from your corporation by having your corporation declare a dividend. Once a dividend is declared on a particular class of shares, all shareholders with that class of shares must receive a dividend in proportion to the number of the shares held.

A dividend payment is not subject to the reasonableness test in relation to work performed. Instead, corporate solvency tests may need to be used and restrictions on the capital stock itself should be identified when determining whether a dividend can be paid and the amount of the dividend that can be paid. There may also be tax considerations.

At the corporate level

A dividend payment is not a deductible expense for your corporation. Dividends are paid out of your corporation's after-tax profits or retained earnings, which means they've already been subject to a level of tax within the corporation. When your corporation pays you a taxable dividend, it may be entitled to receive a refund of a portion of corporate taxes paid.

Your corporation may pay both "eligible" and "non-eligible" dividends.

Eligible dividends

An eligible dividend is a taxable dividend that your corporation designates to be eligible. Your corporation can pay eligible dividends to the extent that its ABI is taxed at the high general corporate tax rate. Although passive investment income (which includes interest income, foreign income, rental income, royalty income and taxable capital gains) is taxed at a high rate in the corporation, this type of income can't generally be paid out as eligible dividends. Your corporation can also pay eligible dividends to the extent of the eligible dividends it receives.

Non-eligible dividends

A non-eligible dividend is a taxable dividend your corporation has not designated to be eligible. ABI taxed at the small business corporate tax rate and passive investment income (other than eligible dividends received from other corporations) earned in your corporation can be paid out as non-eligible dividends.

The purpose of the gross-up and tax credit rules for dividends is to achieve what's commonly referred to as "integration," an important Canadian tax system principle. When a tax system is perfectly integrated, an individual should pay the same amount of tax regardless of whether the income is earned personally or through a corporation.

At the individual level

You pay personal tax on a taxable dividend at your marginal tax rate. At the individual level, eligible dividends are taxed at a lower rate than non-eligible dividends. You have to gross up a dividend payment by a certain percentage depending on whether it's eligible (38%) or non-eligible (15%) to arrive at the taxable amount that's included in your income. For example, if you receive an actual dividend of $1,000, you'll need to include $1,380 or $1,150 of income on your tax return depending on the type of dividend you receive. Due to this gross-up, the amount of the taxable dividends may have a bigger impact on your eligibility for certain income-tested benefits, such as the Old Age Security.

For federal tax purposes, dividends are eligible for a non-refundable dividend tax credit on the grossed-up dividend amount. This dividend tax credit is meant to reflect the corporate taxes already paid on this income prior to distribution. There's also a provincial/territorial dividend tax credit available, which differs for each province/territory.

Integration

The purpose of the gross-up and tax credit rules for dividends is to achieve what's commonly referred to as "integration," an important Canadian tax system principle. When a tax system is perfectly integrated, an individual should pay the same amount of tax regardless of whether the income is earned personally or through a corporation. Therefore, the dividend tax system provides recognition of the taxes already paid by the corporation for the eligible and non-eligible dividends accordingly.

Under the current tax rates, integration is not quite perfect. There may be an advantage or disadvantage to earning income in a corporation and then paying out a dividend to the shareholder depending on your province/territory of residence. For more information on integrated tax rates, ask your RBC advisor for the integrated tax tables for active business income and investment income.

In addition to the integrated rate, you should take into account the payroll taxes that your corporation will incur if paying a salary versus a dividend. A qualified tax advisor can help you determine whether it makes sense for you to receive a salary or taxable dividends from your corporation.

Planning strategies using dividends

Refundable dividend tax on hand (RDTOH) and the dividend refund

The RDTOH is a notional account that keeps track of refundable taxes paid by the corporation on passive investment income. If there's a positive balance in the RDTOH account, the corporation will receive a refund when it pays a taxable dividend to a shareholder (the "dividend refund"). The corporation receives a dividend refund at a rate of 38$^{1/3}$% of the taxable dividends it pays. The dividend refund is limited to the balance in the RDTOH account.

If your company has an RDTOH balance and you have a low marginal tax rate in the current year, consider paying yourself a dividend up to the point where your marginal tax rate on the dividend reaches the dividend refund rate in the corporation of 38$^{1/3}$%. This strategy will provide you and your corporation with more cash flow overall, since the dividend refund to your corporation may be more than your personal tax on the dividend you received.

Your corporation will generally only receive a dividend refund on the payment of non-eligible dividends. An exception will be provided where the RDTOH arises from eligible dividends received by the corporation on portfolio investments. In this case, the corporation will be able to obtain a dividend refund upon the payment of eligible dividends. For a more detailed discussion about the RDTOH and dividend refund, please ask your RBC advisor for the article on the taxation of investment income in a corporation.

Dividend sprinkling

A common income-splitting strategy that has often been employed by high-income business owners or incorporated professionals to reduce the overall taxes paid on income earned inside a corporation is to pay dividends to lower-income family members who are shareholders. This income-splitting strategy is sometimes referred to as "dividend sprinkling." However, this strategy was significantly curtailed by the expansion of the tax on split income (TOSI) rules since 2018.

The TOSI rules limit income splitting with family members, such as your spouse and children, who receive certain amounts directly or indirectly from a related business. A related business is one where a person is related to an individual who's either actively engaged in the business or owns a significant portion of the equity in the corporation

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that carries on the business. Where TOSI applies, the income is taxed at the highest marginal tax rate and the person receiving the income loses the ability to claim personal tax credits, other than the dividend tax credit, the disability tax credit and foreign tax credits.

There are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults who are 18 to 24 years old, and adults age 25 and over. There's also an exclusion available to the spouse of a business owner where the business owner is age 65 or over. The exclusions mainly rely on whether the family member is significantly involved in the business or owns a certain portion of the votes and value of the qualifying corporation's shares. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask your RBC advisor for the article discussing income splitting through private corporations.

Given the complexity of the tax rules surrounding paying dividends to family members, you should get a qualified tax advisor involved to ensure that income splitting through your corporation is right for you.

Providing a shareholder loan

You may be asking, if I need to access money from my corporation, why not simply borrow it from my corporation? The Income Tax Act (ITA) contains very specific rules limiting the ability of a shareholder to borrow funds from their corporation. The general rule is that if you borrow funds from your corporation and the loan isn't repaid within one year after the end of your corporation's fiscal year-end in which the loan was made, the amount borrowed is included in your personal income in the year you borrowed the money. For example, if your corporation's year-end is December 31 and you borrowed money on November 1 of Year 1, you'd have to repay that loan by December 31 of Year 2 to avoid the income inclusion on your personal tax return for Year 1.

In situations where you're subject to the income inclusion, you'll receive a deduction on your personal tax return in the year you repay the loan. It's not possible to avoid these rules if you borrow funds, repay them within the

time frame allowed but then immediately re-borrow the funds. This is known as a series of loans and repayments and would not avoid the income inclusion rule.

There are a few exceptions to the income inclusion rules where the loan is made to you in your capacity as an employee and not as a shareholder. The first exception is a loan made to an employee/shareholder who owns less than 10% of the shares of the corporation. The other three exceptions apply to loans used for very specific purposes: the purchase of a home, the purchase of a car for use in carrying out the duties of employment, and the purchase of treasury shares of the corporation. To qualify for an exception, at the time the loan is made, there must be a bona fide arrangement to have the loan repaid within a reasonable time.

Even if you meet these exceptions or the loan is repaid in time so there's no income inclusion, you may still have a deemed interest benefit that's taxable to you if the loan is a no- or low-interest bearing loan A low-interest bearing loan is a loan that charges an interest rate below CRA's prescribed rate.

It's important to note that pursuant to the TOSI rules mentioned previously, in certain circumstances, a shareholder loan may be considered split income that could be subject to TOSI. Given the complexity of the shareholder loan rules as well as the TOSI rules, it's important that you speak with a qualified tax advisor if you want to borrow from your corporation.

Using corporate assets as collateral

Let's say instead of borrowing money from your corporation, you borrow money from a third party, such as a financial institution. As part of the lending arrangement, the third party requires you to have your corporation guarantee the loan and/or to provide security as collateral for your personal loan. In an arrangement like this, your personal loan from a third party may be deemed to be a loan made directly from your corporation to you as the shareholder, causing an income inclusion for you in certain circumstances. The amount of the income inclusion is equal to the lesser of the amount of your personal loan from the third party and the total fair market value of the collateral provided by your corporation.

In situations where these rules apply, if your personal loan from the third party is repaid by the end of your corporation's taxation year following the year you borrowed the funds, the income inclusion will be avoided. For example, if your corporation has a September 30 year-end and you borrow funds in July of Year 1, to avoid the income inclusion, the loan from the third party must be repaid by September 30 of Year 2.

If the income inclusion rules don't apply, you still need to consider the shareholder benefit rules. Where you use corporate assets as collateral for a personal loan or your corporation guarantees a personal loan, there can be a taxable benefit to you as shareholder.

If you had to include the amount of your personal loan in your income in the year you borrowed the funds, you may be able to claim a deduction on your personal return in the year any of the following events occur:

- You repay all or a portion of the amount owing on your personal debt to the third party
- There's a decrease in the fair market value of the property provided as collateral by your corporation
- The collateral arrangement is extinguished

To avoid the application of these rules, the guarantee or collateral agreement should be drafted so the corporation only guarantees the particular personal loan of the shareholder from the lender, and corporate assets provided as security can only be used to repay the particular personal loan of the shareholder and any accrued interest. There are other circumstances where these rules may apply which are beyond the scope of this article.

If the income inclusion rules don't apply, you still need to consider the shareholder benefit rules. Where you use corporate assets as collateral for a personal loan or your corporation guarantees a personal loan, there can be a taxable benefit to you as shareholder. This taxable benefit relates to the use of corporate collateral or receiving a benefit, such as reduced interest rates, because of the corporate guarantee. The amount of the taxable benefit may vary depending on the structure of the loan and surrounding circumstances. To mitigate this benefit, it may be possible to pay your corporation an appropriate fee.

Speak to a qualified tax advisor if you're considering a personal loan where the lending arrangement with the financial institution or other arm's length lender may involve your corporation.

Tax-free withdrawals

Paying a capital dividend

The capital dividend account (CDA) is a notional account. It keeps track of the non-taxable portion of capital gains and the non-allowable portion of capital losses as well as other amounts such as capital dividends received or paid by the corporation and certain life insurance proceeds

received in excess of the policy's adjusted cost base. It's intended that the tax-free character of these amounts be transferable to shareholders. As such, when there's a positive balance in the CDA, a tax-free capital dividend can be paid to the company's shareholders. Once a capital dividend is distributed, the CDA is reduced by the amount of the capital dividend paid.

The CDA does not appear on your company's financial statements, nor does it have to be disclosed anywhere. However, you should maintain an annual balance of the account and closely monitor it to allow you to take advantage of any tax-free capital dividends. As a planning strategy, since the non-allowable portion of capital losses immediately reduces the CDA, it may be beneficial to pay a capital dividend when the CDA is positive so the opportunity is not lost in cases where the corporation realizes a capital loss in the future.

Reducing paid-up capital (PUC)

The PUC of your shares represents the consideration your corporation received in return for the shares it issued. For example, upon creating your corporation, if you contributed $20,000 worth of assets to your corporation, you could receive shares with a PUC of $20,000.

In some cases, your corporation can return the PUC to you tax-free as return of capital. You may want to do this in the case where your corporation no longer needs the funds for its operations. The rationale for this tax-free return is that PUC was contributed from your personal after-tax funds on the initial investment in corporate shares. Therefore, the PUC should not be taxable when it's returned to you.

The determination of PUC for tax purposes can be complicated. In addition, reducing the PUC of the corporation and paying out a tax-free amount may have other negative tax consequences in the future. Consequently, you should consult with a qualified tax professional to determine if reducing the PUC is an appropriate method of withdrawing cash from your corporation in your particular circumstances.

Repaying loans from shareholders

Unlike the issues surrounding shareholders borrowing from their corporation, there are no similar issues in shareholders loaning money to their corporations. Therefore, you may have chosen to finance your corporation in this manner. Perhaps your corporation owes you money because you transferred personal assets to it by way of loan and received no cash or shares in return. Or perhaps your company declared a dividend or a bonus, and you loaned the funds back to your corporation. No matter the reason, when your corporation repays a loan to you, the repayment is not taxable. It's important to note that if a loan is repaid to you by an in-kind transfer of assets, your corporation is deemed to have disposed of the assets at fair market value, resulting in a capital gain or loss. However, the capital loss may be denied and suspended in the corporation until you dispose of the asset to a third party. The fair market value of those assets on the date of transfer becomes your new adjusted cost base going forward.

If you personally paid for expenses that were incurred on behalf of your corporation (for example, entertaining clients), your company can reimburse you for those expenses.

Reimbursing shareholders for business expenses paid

If you personally paid for expenses that were incurred on behalf of your corporation (for example, entertaining clients), your company can reimburse you for those expenses. It's important to keep accurate records and receipts for these expenses paid. When you use your after-tax dollars to pay for business expenses, you don't have to pay income tax on the amounts reimbursed to you by your corporation. In some cases, your company will receive a tax deduction for the business expense.

Conclusion

Determining the most appropriate method or combination of methods to withdraw surplus cash from your corporation should depend on your facts and circumstances as well as your corporation's financial position. The decision involves an understanding of your general corporate tax structure, your corporation's tax attributes, as well as your personal tax situation. Further, both tax and non-tax factors should be considered. Speak with a qualified tax advisor to ensure that all relevant factors are taken into consideration prior to making a withdrawal from your corporation.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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