TAX PLANNING FOR CANADIAN CONTROLLED PRIVATE CORPORATIONS

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On November 23, 2005, Minister of Finance, Ralph Goodale announced the Government's proposal to reduce income tax rates on "eligible dividends" in an effort to level the playing field between corporations and income trusts. The Government intends to accomplish this by introducing an enhanced gross-up and dividend tax credit mechanism for eligible dividends which will, in theory, finally attain tax integration, regardless of the manner in which the income is earned by the investor (i.e. indirectly *via* a corporate structure or directly as a unit holder of an income trust). The decision to increase the tax credit on payouts while simultaneously opting not to impose a tax on income trust distributions was met with immediate euphoria on Bay Street as the income trust sector and dividend- paying companies surged ahead.

The following table shows the inherent tax advantage of income trusts over corporations prior to yesterday's announcement as compared to the parity that would exist if double taxation (corporate and shareholder) were eradicated.

Table 1:

	Large Corporations		**Income Trusts**
	Current	**Proposed**	
A. Income	100	100	100
B. Corporate tax	(32)	(32)	0
C. Amount distributed to investor	68	68	100
Canadian Taxable Individual Investor			
D. Amount included in income	85	99	100
E. Personal income tax (46% of D)	39	46	46
F. Dividend tax credit	(17)	(32)	-
G. Net personal income tax (E – F)	22	14	46
H. Total tax paid (B + G)	**54**	**46**	**46**

A review of this table illustrates the intent of the Government to "level the playing field" and ensure that, on an overall basis, shareholders should be indifferent as to how they earn income. Whether a corporation earns the income, pays corporate tax and ultimately distributes the net amounts as dividends to the shareholder or the shareholder earns the net amounts directly as a unit holder of an income trust should not result in a significantly different overall tax burden.

What may have gone unnoticed, however, by most Canadian business owners and their advisors is the potential for the proposed reduction in dividend tax rates to completely alter the manner in which owner/manager compensation will be structured in the future.

Before considering the potential repercussions, we must first look at the traditional tax planning for Canadian owned business. For Canadian controlled private corporations ("CCPCs") earning active business income, traditional tax planning would dictate that any active business income earned in excess of the "small business limit" (currently $300,000 on a federal basis) would be paid out to the active shareholder(s) by way of a bonus. The logic behind such planning was to ensure that any income in excess of the "small business limit" would not be subject to double taxation when distributed to the shareholders.

To the extent that the CCPC earned $1,000,000 of active business income and further assuming that such income would be paid out to the individual shareholder, the following table shows the after tax advantage of a "bonus-out" strategy:[1]

Table 2:

	Retain Profits $	"Bonus Out" Profits to Small Business Limit $
Income	1,000,000	1,000,000
Bonus	-	<700,000>
Subtotal	1,000,000	300,000
Corporate tax on first $300,000 – (assume 17%)	<51,000>	<51,000>
Corporate tax on balance – (assume 35%)	<245,000>	-
Subtotal	**704,000**	**249,000**
Personal tax on dividends – (assume 30%)	<211,200>	<74,700>
Personal tax on bonus – (assume 45%)	-	<315,000>
Add: gross amount of bonus	-	700,000
Overall retained cash	**492,800**	**559,300**

Accordingly, one can see that a "bonus-out" strategy clearly results in a greater after tax accumulation for the shareholder. Implementing a "bonus-out" strategy has become a well recognized and accepted strategy for structuring owner/manager compensation.

Included in the Department of Canada's Backgrounder which accompanied the Minister's press release was the following statement:

> "Eligible dividends will generally include dividends paid after 2005 by public corporations (and other corporations that are not Canadian controlled private corporations (CCPCs)) that are resident in Canda and subject to the general

[1] See Appendix A

> corporate income tax rate. In addition, CCPCs will be able to pay eligible dividends to the extent that their income (other than investment income) is subject to tax at the general corporate rate."

Provided the net after-tax amount was distributed to the shareholder as an "eligible dividend" the dividend would be subject to the lower dividend income tax rate. Thus, the portion of net income above $300,000 would represent an "eligible dividend" amount, inviting the question, "is the traditional "bonus-down" strategy, complete with its inherent complexities and uncertainties, now a thing of the past"?

If tax integration can now be attained without the necessity of declaring and paying a bonus several significant tax concerns are alleviated. For example, one of the key concerns shared by tax practitioners involved the inherent risk of the "bonus" being declared unreasonable by CRA. To the extent that such a bonus was not reasonable, section 67 of the *Income Tax Act* could apply to deny the deduction from the CCPC's income, while still subjecting the bonus to tax in the recipient's hands: the classic case of double taxation. Accordingly, the CRA has, over the years, provided administrative guidelines as to when it would invoke section 67 when dealing with the reasonableness of bonuses paid from a CCPC's income. Such administrative criterion is outlined in Technical News #22. Very generally, the CRA's administrative guidelines are as follows:

1. The bonus must be paid to shareholders (either direct or indirect shareholders) of a CCPC.
2. The shareholders/managers who are the recipient of the bonuses must be Canadian residents.
3. The shareholders/managers who are the recipients of the bonuses must be actively involved in the day-to-day operations of the CCPC.

As one can see, such administrative guidelines are not definite in nature. In addition, it is important to note that the CRA's comments are simply administrative guidelines and not law. The courts are not bound by the CRA's administrative guidelines and therefore the risk of a bonus being declared unreasonable has always existed. CRA may also argue that the bonus did not have any business purpose, thereby denying the deduction pursuant to the provisions of paragraph 18(1)(a) of the *Income Tax Act*.

To the extent that bonuses are no longer required to address the tax planning needs of owner/managers, the days of section 67 risks may finally be over.

Time will tell.