Vol. 6 No. 7 November 2003

94 Cumberland Street, Suite 200, Toronto, Ontario M5R 1A3
Telephone: (416) 961-5612 Fax: (416) 961-6158
e-mail: valuators@marmerpenner.com

Marmer Penner Newsletter

Written by Steve Z. Ranot, CA•IFA/CBV
Edited by Michael S. Penner, BBA, CA•IFA/CBV, ASA, CFE

CCRA Change of Position May Impact Access to Corporate Income

For most Canadian controlled private corporations ("CCPC"), it has been prudent tax planning to pay salaries and bonuses to the owner/manager when the corporation's taxable income exceeded the small business deduction limit of $200,000 per annum. While the small business deduction threshold has changed over the last few years due to amendments to federal and provincial tax thresholds, the incentive continues to exist with respect to paying such salaries and bonuses. The rationale is that a taxpayer is better off paying the high rate of personal tax of about 46% on the excess salary rather than paying the high rate of corporate tax of approximately 40% and still be faced with paying an additional 31% of the remainder as a dividend tax to subsequently distribute these amounts if retained in the corporation.

The *Income Tax Act* contains a provision that in order to be deductible, an expense must be reasonable. Canada Customs and Revenue Agency ("CCRA") had long accepted that any salary or bonus paid to the owner/manager is reasonable given that a business' success is so dependent on the owner/manager's skills. From a family law standpoint, this was consistent with the premise that barring economic/business constraints, a spouse who owns and controls a corporation generally has access to its income.

A few months ago concerns arose that CCRA would challenge the reasonableness of salaries and bonuses when trusts and holding corporations were interposed between the operating company and the ultimate individual shareholder. A recent CCRA statement made at this year's Canadian Tax Foundation Conference suggests that CCRA will no longer have a blanket policy with respect to the reasonableness of salaries paid to an owner/manager. At this conference, CCRA apparently indicated that it does not consider certain types of income to fall within

its general bonus policy, such as extraordinary income realized from the sale of assets, amounts derived from management fees or dividends flowed through a complex corporate structure and income earned by a corporation prior to achieving its CCPC status.

The first item can be particularly problematic when determining income of a spouse. An operating corporation may choose to sell off excess real estate, for example, and earn a significant gain therefrom. Prior to CCRA's recent change of heart, the taxpayer might have preferred to cause the corporation to pay a salary to offset this significant gain, in order to minimize corporate income taxes. In the face of possible new rules, the taxpayer may be unable to pay such a large bonus resulting in more income being left to be taxed in the corporation. As a result, the taxpayer and his corporation may pay more income tax as a result of CCRA's change of heart. The taxpayer's former spouse may receive less spousal and child support for the same reason as the taxpayer no longer has the same level of after-tax access to corporate income.

* * * * *