Handle owner-manager compensation with care

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As we enter tax filing season next month, owners of businesses will need to finalize the amount and nature of their compensation.

Proper documentation and tax planning are the keys to avoiding disputes with the Canada Revenue Agency (CRA). This is all the more so with owner-manager corporate compensation, for which there are both corporate and personal tax considerations.

The objective of ownermanager compensation is to balance the corporation's cash needs with the optimum tax consequences of the manner of corporate payouts. This requires consideration of deductions and credits available to individuals, earned income requirements for deferred retirement plans, and tax minimization of corporate taxes.

The primary corporate consideration in determining salary levels is to ensure that the amount paid is reasonable in the circumstances of the business. The corporation can only deduct a reasonable amount, but the owner is taxable on the entire payout, whether reasonable or not.

This imbalance is usually not a problem in arm's length relationships because employers do not like to pay unreasonable amounts. However, it can be a serious issue in situations where the employee is a controlling shareholder, or the spouse, or relative, of the shareholder. In non- arm's length relationships, the best test is comparable compensation in arm's length situations for equivalent businesses, according to their gross revenues and profitability.

The usual tests for determining comparable compensation are: Reasonableness in light of the services rendered; Real and meaningful services; Objective criteria in light of the particular business and industry.

The initial test is objective. Because the amount deducted by the corporation is taxable to the employee, the CRA has a high degree of tolerance for the actual amount of salary paid to the ownermanager, particularly where the shareholder's personal tax rate is higher than the corporate rate.

Management bonuses, however, pose special problems, and should be supported by appropriate resolutions of directors and corporate policies, and should be certain in amount and terms of payment. Uncertain amounts and conditions may result in the bonus being considered non- deductible as a contingent liability.

A contingent liability is a liability that depends on an event that may or may not happen. The test is whether a legal obligation comes into existence at a point in time, or whether it will not come into existence until the occurrence of an event which may never occur. Further, a taxpayer may not deduct certain prepaid expenses before the year to which they relate.

In order for a corporation to deduct an accrued amount, the corporation must be l egally obliged to pay the amount, and it should not be contingent on some uncertain event. Otherwise, the amount is deductible only in the year that the corporation actually pays the bonus. Hence, it is important for the corporate directors to record appropriate resolutions in support of the legal obligation to pay the accruals.

The corporation can deduct a bonus that it declares in a fiscal year, but only if it pays it within 179 days of the end of the taxation year. Hence, there is a small opportunity for tax deferral, as the employee can defer tax until the year the bonus is actually paid. For example, where a corporation declares and accrues a bonus on Dec. 31, 2016 and pays the bonus on March 31, 2017, the employee is not taxable until 2018. However, the corporation must still withhold tax, which blunts the benefit of the overall tax deferral.

Where a Canadian Controlled Private Corporation (CCPC) has active business income(ABI) exceeding its annual business limit of $ 500,000 (2017), it can "bonus down" to the limit by paying the bonus to its shareholder-owner. The general effect of "bonusing down" to the limit is to reduce the CCPC's tax rate. However, the share holderowner is taxable on the amount of t he bonus as employment income in the year that corporation pays it.

Careful attention to planning shareholder compensation will save the taxpayer considerable expenses in resolving disputes with the CRA if they challenge the amount of payments to owner managers at a later date. The taxpayer will need to amass a volume of information to prove that the compensation was reasonable considering the industry, market conditions at the relevant time, and the owner's time commitment to his or her corporation. All this, while the CRA sits back and compounds daily interest on its assessment. Plan now or pay later.

MANAGEMENT BONUSES, POSE SPECIAL PROBLEMS.