The Great Deferral:

Compensation Planning in a High Tax Rate Environment

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Changes in 2016

- On December 7, 2015, the Government announced
  - a 1.5% tax cut for middle income tax bracket ($45,282 up to $90,563)
  - Introduction of a new marginal tax bracket for income exceeding $200,000, applicable rate is 33%, a 4% increase over former top tax rate of 29%
- New rates were effective January 1, 2016

Corporate Changes

- As a result of the increased top personal tax rate, changes introduced to reduce deferral possibilities within corporation
  - Refundable tax on CCPC's Aggregate Investment Income increased from 6 2/3% to 10 2/3%
  - The refundable portion of Part I tax included in RDTOH increased from 26 2/3% to 30 2/3%
  - Part IV Tax payable on assessable dividends increased from 33 1/3% to 38 1/3%
  - Dividend Refund Rate increased from 33 1/3% to 38 1/3%

What Does This Mean For The Owner Manager?

- **Option 1: Pay personal tax now**
  - Owner manager is paid a **salary** (treated as an employee) and is taxed on employment income
  - Corporation deducts salary paid from corporate income and pays employer portion of CPP – no corporate tax paid on earnings

- **Option 2: Defer personal tax**
  - OM is paid a **dividend** out of AFTER TAX corporate earnings – corporation pays tax on earnings first and left over cash can be distributed as a dividend now or later
  - OM pays tax on dividend received when it is received

What tax can be deferred?

Option 1: Earn income personally or earn through a corporation but extract as a salary

Business Income	$100,000
Personal Tax (2016 ON)	($53,530)
Net After Tax Cash	$ 46,470

Option 2: Earn income through a corporation (and extract later as a dividend) – assume small business deduction available

Business Income	$100,000
Corporate Tax (2016 ON)	($15,000)
Net After Tax Cash	$ 85,000

Difference of $38,530 (or 38.5%) is the amount of tax deferred

Tax Deferral On Active Business Income

Deferral	BC	AB	SK	MB	ON
2015	32.3%	26.3%	31.0%	35.4%	34.0%
2016	34.7%	34.5%	35.5%	39.9%	38.5%
Deferral	**PQ**	**NB**	**NS**	**NL**	**PEI**
2015	31.0%	39.8%	36.0%	29.3%	31.9%
2016	34.8%	38.8%	40.5%	34.8%	36.4%

What tax can be deferred?

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Business Income	$100,000
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Net After Tax Cash	$ 46,470

Option 2: Earn income through a corporation (and extract later as a dividend) – small business deduction **NOT** available

Business Income	$100,000
Corporate Tax (2016 ON)	($26,500)
Net After Tax Cash	$ 73,500

Difference of $27,030 (or 27%) is the amount of tax deferred

Tax Deferral – General Rate Business Income

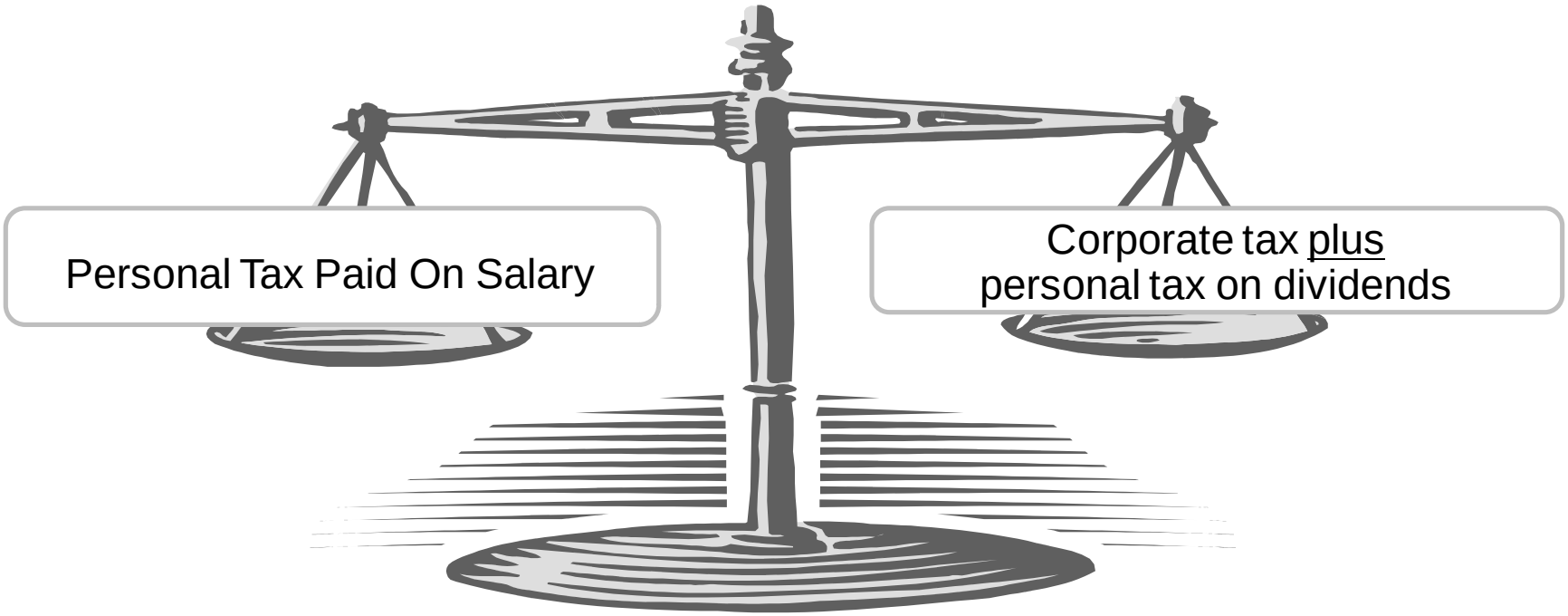
Deferral	BC	AB	SK	MB	ON
2015	19.8%	14.3%	17.0%	19.4%	23.0%
2016	21.7%	21.0%	21.0%	23.4%	27.0%
Deferral	**PQ**	**NB**	**NS**	**NL**	**PEI**
2015	23.1%	27.8%	19.0%	14.3%	16.4%
2016	26.4%	24.3%	23.0%	19.3%	20.4%

Focus on Tax Deferral

- Increased since introduction of “eligible dividends” in 2007
- Increase in personal tax rates
- Decrease in corporate tax rates

- Owner-managers (OM) will look for opportunity to defer paying personal tax

Revisiting Integration



Integration is not perfect!

Integration

- Concept that a dollar earned personally will be subject to the same overall taxation as a dollar earned corporately and extracted as a dividend
- When tax rates are legislated by multiple governing bodies with different goals and mandates, integration will be nearly impossible to achieve
- How does this imperfection affect compensation planning?

Integration – Active Income Eligible for SBD

2016	BC	AB	SK	MB	ON
Tax deferral	34.7%	34.5%	35.5%	39.9%	38.5%
Tax savings/ cost	-0.6%	-0.3%	0.4%	-1.0%	0.0%
2016	**PQ**	**NB**	**NS**	**NL**	**PEI**
Tax deferral	34.8%	38.8%	40.5%	34.8%	36.4%
Tax savings/ cost	-0.9%	0.0%	0.0%	0.7%	-0.9%

Integration – General Rate Business Income

2016	BC	AB	SK	MB	ON
Tax deferral	21.7%	21.0%	21.0%	23.4%	27.0%
Tax savings/ cost	-1.5%	-2.2%	-1.1%	-4.2%	-1.9%
2016	**PQ**	**NB**	**NS**	**NL**	**PEI**
Tax deferral	26.4%	24.3%	23.0%	19.3%	20.4%
Tax savings/ cost	-2.7%	-1.4%	-5.7%	-8.0%	-3.2%

What does this mean for the Owner-Manager?

- Owner manager needs to:

1) determine if there's a tax cost to earning income through a corporation, and
2) to see if that cost can be offset

- The cost of the deferral may be offset when:

  - The business benefits from the use of more after-tax cash (deferred amount)
  - The corporate investment earns a greater rate of return than personal investment
  - Profits can eventually be extracted by way of dividend at a lower personal tax rate

What about other types of income?

- Investment income is subject to **higher** rates of tax inside the corporation

- Recent changes were made to **preserve integration** which impacted the tax deferral available and the tax costs or tax savings to be had by earning income through a corporation

Integration – Investment Income: Interest

2016	BC	AB	SK	MB	ON
Tax deferral	-2.0%	-2.7%	-2.7%	-0.3%	3.4%
Tax savings/ cost	-4.2%	-4.2%	-3.9%	-6.2%	-2.4%
2016	**PQ**	**NB**	**NS**	**NL**	**PEI**
Tax deferral	2.7%	0.6%	-0.7%	-3.9%	-3.3%
Tax savings/ cost	-1.7%	-4.8%	-6.9%	-6.5%	-7.4%

Integration – Investment Income: Eligible Dividends

2016	BC	AB	SK	MB	ON
Tax deferral	-7.0%	-6.6%	-8.0%	-0.5%	1.0%
Tax savings/ cost	0.0%	0.0%	0.0%	0.0%	0.0%
2016	**PQ**	**NB**	**NS**	**NL**	**PEI**
Tax deferral	1.5%	-2.1%	3.3%	2.2%	-4.1%
Tax savings/ cost	0.0%	0.0%	0.0%	0.0%	0.0%

Case Study #1 – Alberta

- Highest marginal tax rate increased dramatically for individuals in AB

Top Rate	2014	2015	2016
Income	39.00%	40.25%	48.00%
Capital Gains	19.50%	20.13%	24.00%
Eligible Dividends	19.29%	21.02%	31.71%
Other than Eligible Dividends	29.36%	30.84%	40.24%

Case Study #1 – Alberta

- In 2014, the corporate deferral on income eligible for the SBD was only 25%

- Now the deferral has **increased** to 34.5%, budgeted to increase to 35.5% in 2017 – creates more of an incentive to incorporate and defer income within an Alberta corporation

Case Study #1 – Alberta

- OM's in Alberta had **less** of a deferral available to them annually – 25% vs. over 30% in other provinces
- The overall cost of earning income eligible for SBD in 2014 was only 0.25%; 2016 cost is now 0.31%
- Benefit was the extraction of corporate profits at a low flat provincial tax rate

Case Study #1 – Alberta

- Consider an OM who earned small business income through a **Manitoba** corporation, experiencing a 35.4% deferral in 2014
- Business ceases operations, OM moves to Alberta, begins to extract the deferred corporate profits personally
- How did he previously benefit? Has that benefit changed in 2016?
- How does this affect integration?

Case Study #1 – Alberta

Tax Deferral in Manitoba and Extraction in Alberta	Extracted in 2014	Extracted in 2016
Business income earned in Manitoba	$ 100,000	$ 100,000
Manitoba Top marginal personal tax rate in 2014	46.40%	46.40%
Net personal income after tax	$ 53,600	$ 53,600
Business income earned in Manitoba	$ 100,000	$ 100,000
MB corporate tax rate on active income earned eligible for the SBD in 2014	11.00%	11.00%
Net corporate income available to distribute	$ 89,000	$ 89,000
Alberta Top marginal tax rate for non-eligible dividend in 2014 - 29.36%	29.36%	
Alberta Top marginal tax rate for non-eligible dividend in 2016 - 40.24%		40.24%
Net Personal Income	$ 62,870	$ 53,186
Tax Savings (Cost) of earning active income through a corporation	$ 9,270	$ (414)
Tax Savings (Cost) expressed as a percentage	**9.27%**	**-0.41%**

Case Study #1 – Alberta

- AB deferral % now on par with other provinces
- Dividend rates have changed by more than 10%
- Tax rates can impact compensation planning

General Rules of Thumb

- When would an OM prefer a salary over a dividend?

  - Funds needed **immediately** for personal expenses
  - Worried about creditor protection if funds are retained in the corporation
  - Desire to invest within a RRSP
  - Wants "guarantee" associated with **CPP**
  - Wants to participate in group benefit plans

General Rules of Thumb

- When would an OM prefer a dividend over a salary?
  - Able to achieve **permanent** tax savings by deferring corporate distribution
  - Able to receive an eligible or capital dividend
  - Concerned that a salary would be subject to **reasonability** tests
  - Want to reduce payroll withholdings and other deductions such as provincial payroll/health taxes

Long-Term Approach

- When determining a compensation strategy, tax savings vs. tax cost analysis is not **enough**
- How does the investment of excess cash affect wealth accumulation under a salary or dividend strategy?
- Where does the OM **build** his or her wealth?

Case Study #2 – Investment Outcome

- Analyzes the overall wealth accumulation of an investment within an RRSP via salary compensation strategy vs. an investment within the corporate structure extracted as a dividend during retirement
- Assumes balanced portfolio investment earning mix of deferred growth, dividends, interest, and capital gains
- Overall rate of return is 2.75% (adjusted for inflation of 2%)
- Assume Alberta Corporation/Alberta Resident Aged 45, previously maximized RRSP contributions from age 25 to 45

Case Study #2

Investing within a RRSP or within the Corporation	Salary	Dividend	Difference
Corporate Business Income	143,489	143,489	
Salary Paid to Owner-Manager	(140,945)		
CPP Contributions - Corporate	(2,544)		
Corporate Tax	-	(17,936)	
Dividend Paid to Owner- Manager	-	(97,880)	
Retained Earnings	-	27,673	
Personal Income	140,945	97,880	
RRSP Contributions	(25,370)		
CPP Contributions - Personal	(2,544)		
Personal Tax	(29,781)	(14,630)	
Net Personal Income (Available for Consumption)	83,250	83,250	
RRSP/Corporate Savings at Retirement (Accumulated over 20 years)	682,905	715,032	32,127
a) Lump Sum Withdrawal (After-tax) - at Retirement	387,151	473,567	86,416
b) Annual After-Tax Income Stream- Paid Over 25 Yrs			
Income from RRSP/ Corporate Investment Savings	61,244	66,188	4,944
Income from CPP&OAS	12,148	7,998	(4,150)
	73,392	74,186	794

Case Study #2

- When utilizing a dividend strategy, **more** funds are available for retirement
- If income were to be fully recognized at the time of retirement, benefit of dividend strategy is significant
- If income earned during entire retirement period of 65 to 90 years of age, overall difference between the two strategies is **minimal** when CPP entitlement differences are factored in

Case Study #2

- What **happens** if the investment strategy changes from moderate to a conservative interest only investment?

- Does this type of investment strategy **favour** RRSPs or Corporate Investment?

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Corporate Tax	-	(17,936)	
Dividend Paid to Owner- Manager	-	(97,880)	
Retained Earnings	-	27,673	
Personal Income	140,945	97,880	
RRSP Contributions	(25,370)		
CPP Contributions - Personal	(2,544)		
Personal Tax	(29,781)	(14,630)	
Net Personal Income (Available for Consumption)	83,250	83,250	
RRSP/Corporate Savings at Retirement (Accumulated over 20 years)	682,905	658,247	(24,658)
a) Lump Sum Withdrawal (After-tax) - at Retirement	387,151	425,735	38,584
b) Annual After-Tax Income Stream- Paid Over 25 Yrs			
Income from RRSP/ Corporate Investment Savings	61,244	61,490	246
Income from CPP&OAS	12,148	8,013	(4,135)
	73,392	69,503	(3,889)

Case Study #2

- Interest only investment will yield **less** overall wealth accumulation within the corporate structure
- If income needed immediately upon retirement, dividend strategy still favoured due to taxation of RRSP
- If income is received during the anticipated retirement period, the RRSP strategy yields **more** after-tax cash to OM

Case Study #2: Take Away

- Compensation Strategy may be **affected** by Investment Strategy

Dividend Strategy: Deferral Opportunity

- Key aspect of earning income corporately is the deferral of personal tax
- **Cost** of earning income within corporation can be offset when:
  - The business benefits from the use of more after-tax cash
  - Deferred cash earns a greater rate of return
  - Profits are eventually extracted at lower personal tax rates

Deferral Strategy: Hard Facts

- In 2016, 10 out of the 13 Provinces and Territories have a top marginal tax rate **exceeding** 48%
- For income eligible for the SBD, the deferral % ranges from 34.5% to a whopping 40.5% in Nova Scotia!
- The **allure** of corporate deferral is significant in today's tax environment

Potential Pitfalls to Deferral

- With such **incentive** to defer, what are some potential issues that may arise when profits are deferred within the corporate structure?
  - Income Splitting
  - Successful Succession
  - Restricted Corporate Structure

Case Study # 3: Avoiding Corporate Attribution

- Case Study 3 – William and Catherine

- William is 48 years of age, married to Catherine
- They have three children, two of whom are over the age of majority
- William and Catherine believe they should cover the costs of schooling to allow their children to focus on their studies
- William is the sole shareholder of a corporation with average taxable income of $400k, previously has only needed $200k of income for personal needs, remaining $200k corporately invested
- Catherine has recently quit working, therefore, income splitting is now appealing to William

Case Study # 3: Avoiding Corporate Attribution

- Has William's corporate deferral strategy affected his ability to implement other tax planning?
- OM wishes to implement an estate freeze in favour of a discretionary family trust to allow for income splitting with Catherine and the adult children
- However, due to $200k being invested corporately on an annual basis in passive investments, the operating company is not a Small Business Corporation

Case Study # 3: Avoiding Corporate Attribution

- If company does not achieve or maintain SBC status, payments to Catherine will trigger a deemed interest benefit taxable to William unless sufficient dividends paid on his freeze shares
- To continue the deferral, William and his corporation will have to undertake a series of steps to shift the passive investments to a separate investment company
- A corporate beneficiary of the trust can be used to ensure SBC status is always maintained

Case Study #4: Successful Succession

- Case Study #4 – Kevin
- Excess profits always reinvested within active business of company, no investments, no cash retained
- Kevin wishes to implement an estate freeze in favour of key employee
- Kevin will redeem his shares over a 20 year period
- What issues may arise when the company is solely responsible for funding retirement?

Case Study #4: Successful Succession

- Potential conflict between Kevin and key employee
- Should positive cash flow be first allocated to redemption strategy? What if reinvestment of profits is a key success factor of company?
- Does negative cash flow result in need for debt or does it affect amount and pace of redemption schedule?
- Could personal investments have provided some “insurance” for the exit strategy so Kevin is not completely dependent on company for retirement cash flow?

Case Study #5: Restricted Structures

- Case Study #5 – Lynda The Incorporated Professional
- Certain professionals in Alberta and Ontario have share ownership restrictions
- Do such restrictions affect the use of the dividend strategy?
- Balancing act between deferral and protection of wealth

Increasing Complexity

- To **accommodate** the deferral, increasing level of complexity in corporate structures
- Conflict between deferral and maintaining QBSC status
- Do OM's **understand** the structures in which they operate?
  - Increased compliance
  - Increased audit risk
  - Increased complexity for estate management

Impact of Deferral: Owner-Manager's Death

- Impact of personal wealth accumulated within corporate structure is two-fold
- Greater need for estate freeze to cap the estate liability of the OM
- Often OM dies with owning some **remaining** corporate value

Impact of Deferral: Owner-Manager Death

- Creates need for planning post-death to remedy double tax
  - 164(6) Election
  - Pipeline Planning
  - Hybrid

- If OM is unlikely to require significant portion of accumulated capital for retirement needs – life insurance can provide a solution to double taxation

Too Much Deferral?

- Under **utilizing** marginal tax brackets
- Use of TFSAs to earn income
- Personal wealth generation within tax efficient investments to negate deferral pitfalls

Conclusion

- Cost of deferral continues to **decline**
- In current tax environment, increased incentive to defer
- Analysis should extend beyond typical tax savings vs. tax cost – deferral can affect other aspects
- Tax savings alone may not measure the success of a chosen compensation plan – focus on OM goals and where to build their wealth

Questions