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Tax Planning for Owner-Managers In Ontario

Leaving Income in Corporations vs. Paying Out as Management Salaries or Bonus to Owner-Manager(s)

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In light of recent federal and Ontario changes to corporate tax rates and brackets, and the announcements made in yesterday's federal budget, the old strategy of paying bonuses to an owner-manager of a Canadian-controlled private corporation ("CCPC"), against corporate taxable income in excess of \$200,000, may no longer be the optimal alternative. The purpose of this memorandum is to outline the recent changes, and their impact on retaining income in a CCPC.

Background

Where active business income is earned through a corporation, there are ultimately two levels of tax. The first imposition of tax is at the corporate level, and the second is at the personal level i.e. when the corporation distributes its after-tax retained earnings as dividends to the individual shareholder(s). The effect of the two levels of tax can result in greater overall tax than if the same income had been earned personally. However, when one considers that the shareholder level of tax can be deferred to the future by not paying the dividend, the time value of this tax deferral can more than offset such greater overall tax.

Previously, it was generally not advantageous for a CCPC to leave income in excess of \$200,000 in the company, because it normally resulted in greater combined tax. Furthermore, where taxable income of a CCPC exceeded \$200,000, the Ontario government clawed back some or all of the Ontario tax benefit associated with its low rate of tax applicable to the first \$200,000 of taxable income. Consequently, most CCPCs retained no greater than \$200,000 of annual taxable income, with the balance being paid out as a bonus to the owner/manager(s). **It should be noted that these comments apply to a CCPC whose taxable capital for purposes of the federal Large Corporations Tax does not exceed \$10 million, since such a CCPC would either not benefit, or only partially benefit, from the low rates of tax applicable to such income.**

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Starting with calendar 2001, both the federal and Ontario governments will be gradually reducing their corporate tax rates. In addition, both governments will be increasing the levels of income subject to the low rates of corporate tax (the “Small Business Limit”). These changes are scheduled to take place annually, and are scheduled to be fully implemented by 2006.

The following is a brief summary of the changes that are scheduled to occur¹:

Federal Changes

The general federal corporate income tax rate, including the corporate surtax of 1.12%, has been reduced from 29.12% in 2000 to:

- 28.12% in 2001
- 26.12% in 2002
- 24.12% in 2003
- 22.12% in 2004 and thereafter.

The reduced rate will not apply to investment income earned by a CCPC. The tax rate reduction for manufacturing and processing (“M&P”) income will be eliminated by 2004, coincidental with the reductions in the general corporate tax rates.

The corporate tax rate, including the surtax, pertaining to the Small Business Limit for federal purposes remains unchanged at 13.12%. As a consequence of the announcement made in the 2003 federal budget, however, the Small Business Limit will be increasing for federal purposes from its previous level of \$200,000, as follows:

- \$225,000 in 2003
- \$250,000 in 2004
- \$275,000 in 2005
- \$300,000 in 2006 and thereafter.

Until the general federal corporate income tax rates and Small Business Limit thresholds are fully implemented, a CCPC may benefit from a federal corporate tax rate of 22.12%, for taxable income between \$200,000 and \$300,000. The above changes effectively result in three tax brackets for federal purposes:

- a low rate (13.12%) up to the federal Small Business Limit applicable for the year
- a middle rate (22.12%) on income between the federal Small Business Limit and \$300,000, and
- the general federal corporate tax rate, as described above, on income over \$300,000.

¹ The tax rates and the income levels specified herein are *averaged* for a calendar year for simplicity purposes. The tax rates and income levels changes are prorated for a non-calendar fiscal year-end.

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After 2003, there will no longer be a middle rate, since the general federal tax rate will be 22.12%.

Ontario Changes

The Ontario general corporate tax rate has been reduced from 14.83% in 2000 to:

- 13.625% in 2001
- 12.5% in 2002 and 2003
- 11% in 2004
- 9.5% in 2005, and
- 8% in 2006.

Unlike the general federal tax rate reductions, the reduction in the Ontario general tax rates equally apply to a CCPC's investment income. Similar to the federal changes, however, the 1.875% Ontario M&P credit will be completely eliminated by 2006, coincidental with the full phase in of the reduction in its general corporate tax rates.

The tax rates pertaining to the Ontario Small Business Limit has been reduced from 7.33% in 2000 to:

- 6.375% in 2001
- 6% in 2002
- 5.5% in 2003
- 5% in 2004, and
- 4% in 2005.

In addition to the foregoing, the Small Business Limit for Ontario purposes has been increased as follows:

- \$240,000 from January 1, 2001 to September 30, 2001
- \$280,000 from October 1, 2001 to December 31, 2002
- \$320,000 in 2003
- \$360,000 in 2004, and
- \$400,000 in 2005.

If a corporation earns income in excess of these annual thresholds, the tax rate would be equal to the general rate, plus a surtax designed to clawback some or all of the benefit associated with the low Ontario tax rate for income otherwise subject to the Small Business Limit for Ontario purposes. Because of the clawback, it is generally not beneficial to leave income in a CCPC in excess of the Small Business Limit for Ontario purposes for the year.

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Combined Effect of the Federal and Ontario Changes

The combined effect of the federal and Ontario changes effectively results in five different tax brackets in 2001 and subsequent years. For example, in 2003, the tax brackets are as follows:

- income up to \$225,000 would be subject to low federal (13.12%) and low Ontario rates (5.5%);
- income from \$225,001 to \$300,000 would be subject to mid-federal (22.12%) and low Ontario rates (5.5%);
- income from \$300,001 to \$320,000 would be subject to high federal (24.12%) and low Ontario rates (5.5%);
- income from \$320,001 to \$800,000 would be subject to high federal (24.12%) and high Ontario rates (12.5%), and an Ontario surtax (4.67%) which claws back the benefit pertaining to the low Ontario tax rate on the Small Business Limit for Ontario purposes; and
- income in excess of \$800,000 would be subject to high federal (24.12%) and high Ontario rates (12.5%).

Conclusion

Because of the various tax rate and income bracket changes, the decision as to the quantum of income to retain in a CCPC has become complex. The decision to retain income in excess of the Small Business Limit will depend upon the taxpayer's particular situation. Consequently, we have prepared various schedules (please see attached), which provide information concerning the taxation of corporate taxable income for various income brackets in 2002 and 2003. It is generally beneficial for a CCPC to retain income up to the amount of the annual Small Business Limit. Where the corporation's taxable income exceeds the Small Business Limit, it is necessary to evaluate whether the present value of the tax deferral resulting from retaining the income in the corporation will exceed the present value of the additional tax cost when the shareholder ultimately receives a dividend.

For example, assume a corporation earned \$ 300,000 of taxable income in 2003. Table 6 shows that it is preferable to retain income equal to the Small Business Limit of \$ 225,000, in the corporation rather than paying salary or a bonus to the shareholder. By doing so, the corporation would enjoy an immediate tax deferral of \$ 64,834. When the corporation ultimately pays a dividend to the shareholder, the personal tax thereon will be \$ 57,385. Accordingly, even if the corporation does not defer the payment of a dividend, there is an overall tax savings of \$ 7,449. With respect to the \$ 75,000 band of income in excess of \$ 225,000, the decision as to whether to retain the income in the corporation or whether to pay salary or a bonus to the shareholder is more complex. Where the income is retained and taxed in the corporation, the corporation would enjoy an immediate tax deferral of \$ 14,861. When a dividend is ultimately paid to the shareholder, the personal tax thereon would be \$ 17,013. Accordingly, there is an ultimate tax cost of \$ 2,152 of retaining the income in the corporation and then paying a dividend. Where the payment of the dividend can be deferred, this tax cost would also be deferred. The issue is whether the corporation could earn sufficient after-tax income from the \$ 14,861 tax deferral to

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fund the ultimate tax cost of \$ 2,152. The resolution of this issue will depend on the length of time the payment of the dividend can be deferred and the after-tax investment rate earned by the corporation.

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To fully discuss the impact of the various corporate tax rate changes, we urge you to speak to your partner at Goldfarb, Shulman, Patel & Co. LLP.