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How to Reduce Corporate and Personal Taxes

Owners that do so will increase overall wealth

This article was originally published in the *National Post – Small Business Monday* on July 21, 2009

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Owners that do so will increase overall wealth

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In troubled economic times, it is more important than ever for owners of an incorporated business to find ways to control and reduce corporate and personal income taxes. By not doing so they significantly risk reducing their future wealth.

Here are basic tax-planning steps to help owner-managers tax-effectively get income and capital out of their business:

Determine Your Optimum Salary/Dividend Mix

Owner-managers of incorporated businesses have several alternatives for getting remuneration from their corporations, including receiving a salary and dividends on their shares. Unfortunately, there is no one-size-fits-all approach to determining the most tax-effective split between these, rather it depends on cash flow needs, other income received by the owner, the corporation's status and its income level, and many other factors.

In the past, a good strategy was for a small business corporation to pay enough salary to reduce its income to the small-business limit (currently $500,000 for federal purposes), avoiding any corporate income being taxed at the higher rates applied to income beyond that limit. However, recent changes to the taxation of dividends have upset the old rules of thumb and you may want to revisit this strategy. Be sure to pay yourself enough salary to allow the maximum possible contribution to a registered retirement savings plan and the Canada Pension Plan. The same goes for family members you employ.

Other Tax-Effective Means To Extract Funds From Your Corporation Include:

If you have lent funds to the corporation, it can repay any amount of the loan without tax consequences. Such a repayment is neither deductible to the corporation nor taxable to you. Alternatively, the corporation can pay you interest on the loan. The interest paid will normally be taxable to you as investment income. The tax effect would be about the same as if the corporation paid you that amount in salary. The interest will generally be deductible to the corporation as long as it has a legal obligation to pay it.
– Any amount that is less than the corporation's paid-up capital, or PUC, may be paid out to the shareholders as a repayment of capital, generally with no tax consequences.

If the corporation was originally funded with a substantial amount of capital, consider extracting funds by a reduction of its PUC. Make sure the corporation remains sufficiently capitalized to satisfy any requirements of its creditors or bankers. PUC essentially is the amount of capital contributed to the corporation in exchange for shares. However, the figure can be adjusted for tax purposes in various ways. As such, the legal PUC often differs from the tax PUC.
– Pay capital dividends. Only half of capital gains are taxed. When a private corporation realizes a capital gain, the untaxed portion is added to its "capital dividend account."

Similarly, half of any capital losses reduces the capital dividend account. Any amount in the capital dividend account may be paid out tax-free to its shareholders. This preserves the non-taxability of the appropriate fraction of the capital gain. If the corporation has realized any capital gains (net of realized losses), you should generally cause it to pay out capital dividends as your first choice for extracting funds.

For the dividend payment to qualify for tax-free distribution, the appropriate tax election forms and directors' resolutions must be filed with the CRA before the dividends are declared payable from the corporation. If you do not file the tax elections in advance, penalties could apply. By paying capital dividends, you also avoid the account be wiped out by future capital losses. - Use and multiply capital gains exemption. Individual resident in Canada are entitled to a lifetime capital-gains exemption of $750,000 for qualified small business corporation shares. Thus, if you arrange for your spouse to invest in your corporation, you effectively double the available exemption. Including children directly or through a family trust potentially increases the number of exemptions available, too.

Now that certain business values depressed, it may be a good time to bring family members into owning shares of the corporation to multiply the available exemptions.

To use your capital gains exemption, the corporation must be a qualified small business corporation. One of the primary tests that must be satisfied is that the fair market value of the non-active business assets of the corporation cannot exceed 10% of the fair market value of the total assets.

Other tax planning ideas to explore include estate planning, income splitting, life insurance and incorporating your investments.

Business owners realize reducing their corporate and personal income tax can increase their wealth, whether the economy is booming or in the worst recession in 80 years.

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