

Behind the counter

Income Splitting in a small business

This year the Canada Revenue Agency introduced pension splitting, but there has always been a way to split income with the use of a corporation. The secret is in the way that the shares are set up. If they are set up correctly, you can split income by paying dividends to various classes of shares. The term dividend means the distribution of a share of the profits of a corporation to the shareholders.

Normally the first class of shares is Class A which are the common voting shares and the standard wording in the Articles of Incorporation normally say that no dividends shall be paid on the common shares. You can change the Articles so that dividends can be paid to the common shareholders by removing that sentence if you prefer.

The next Classes of Shares are usually the preferred, non-voting shares without par value. These shares can be assigned to your family members with the view of issuing dividends. A note of caution is that each family member must purchase the shares with their own money. For children, they can purchase the shares with their Child Tax Benefit money if a separate bank account has been set up for them, or a trust could be created to hold the shares for the child. The aim is to avoid the attribution rules whereby any income that you have distributed to your child would get taxed as if you had received it yourself. If Canada Revenue Agency does deem the attribution rules to apply in this type of situation any dividends paid out to a child will be taxed at the top marginal tax rate and payable by the parent.

Finally, the last Classes of Shares are usually the preferred redeemable shares that are utilized when the aim is to create an estate freeze or to sell a company.

Dividends are paid out of the company from the retained earnings account which means that they are paid out after the company has already paid tax on that income. When they are received by the individual they must be grossed up by 25% and then the individual will receive a tax credit of 33%. The reason for this formula is that the tax department was trying to avoid double taxation when the dividends were passed to the individual.

The gross up attempts to restore the amount of the dividend to the amount that the corporation would have paid if there was no corporate tax and the tax credit represents the corporate tax paid.

Here is an example of what this all means. Lets assume that the corporation has retained earnings of approx \$85,000, and cash of about the same amount, so the shareholders decide that they will pay dividends to the Class B shareholders of \$10,000. This decision needs to be documented in the minute book of the corporation by way of a resolution of the shareholders. The shareholders can also decide when this dividend will be paid, so there is some flexibility in tax planning and tax deferral for the shareholder/owner because the dividends are taxable when they are received.

For the corporation, the cash flow is reduced by the amount of dividends and the retained earnings is reduced by the same amount.

The individual will receive a T5 showing the original dividend amount of \$10,000, the grossed up taxable dividend amount of \$12,500 and the dividend tax credit of \$1,670.

So the taxes payable will look something like this:

Dividend	10,000
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Gross up	2,500
Taxable Dividend	12,500
Federal Tax @ 15%	1,875
Less: Dividend Tax Credit	1,670
Total Tax Payable	205
After Tax Income	9,795

To compare that with interest income:

Interest income	10,000
Tax @ 15%	1,500
After tax income	8,500

So in rough numbers the tax savings would be approximately \$1,295 for the individual ignoring all other kinds of income and credits.

There are a couple of points to consider. First is that the tax credit is lost if it is not used. It cannot be carried forward so you want to be careful that your dividend tax credit never exceeds your tax. If you are in this kind of a situation, you would probably want to carry forward any donations or medical expenses that can be carried forward so that you use up your dividend tax credit.

Dividends can be received by shareholders tax free if they are paid out of the corporation's capital dividend account. The capital dividend account holds the non taxable portion of any capital gains and proceeds of life insurance policies realized by the company.

Gabriele Banka, DAcc., CGA is a Certified General Accountant and the owner of Banka & Company Inc. She can be reached at 763-4528 or info@bankaco.com.