FARM ALERT

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February 2017

Methods of drawing funds from a corporation

***Lee Littlejohns, CPA, CA, BAcc** is a manager in the Stratford office of Collins Barrow KMD LLP*

Shareholders and family members of incorporated farming operations have a number of options for receiving compensation from their corporation. These options can range from compensation for services rendered, to a return of equity invested in the corporation or merely income derived from owning shares.

The method by which an individual receives money from a corporation is often driven by a number of factors such as the corporation's taxable income or the level of personal spending by the shareholders. Accordingly, it is important to have an understanding of the tax implications of each method of drawing funds from a corporation. The benefits and costs for each of the typical methods are summarized as follows:

Wages/Salary

- Income received from services rendered, must be *reasonable* for actual work performed

Benefits

- Deductible to the corporation
- Generates Canada Pension Plan (CPP) contributions and Registered Retirement Savings Plan (RRSP) contribution room

Costs

- Corporation will be required to make payroll deductions and report income on T4 slips
- May not be the most advantageous way to report taxable income personally
- Could be subject to Employment Insurance (EI), Employer Health Tax (EHT) and Workplace Safety and Insurance Board (WSIB) premiums

Custom Work

- Income received from services rendered, must be *reasonable* for actual work performed

Benefits

- Same as Wages/Salary discussed above

Costs

- May not be the most advantageous way to report taxable income personally
- Might be subject to GST/HST
- Could be subject to WSIB premiums
- Individual would be required to pay both the employer and employee portion of CPP contributions resulting in a higher perceived income tax liability
- Could result in a payroll review by the Canada Revenue Agency (CRA) to assess whether or not the individual is actually an employee to the corporation or a self-employed contractor which might result in assessed interest and penalties

Land/Building Rent or Interest income

- Income received for personally owned property rented to corporation, or interest on debt the corporation owes to the individual

Benefits

- Deductible to the corporation
- Does not necessarily trigger CPP premiums if these are not desirable
- Does not require the individual to be active in operations,

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only to merely hold debt owing or land used by by the corporation

Costs

- May not be the most advantageous way to report taxable income personally
- Rental income will likely be subject to GST/HST

Draws on Shareholder Loans or Other Debts

Benefits

- Normally a tax-free form of drawing funds from a corporation

Costs

- Some debts are taxable (i.e. taxable inventory notes)
- Excessive draws beyond actual debt lent to the corporation could result in personal tax implications

Dividends or Share Redemptions

- Income derived from shares held in the farming corporation

Benefits

- Can be used as an effective means of remuneration with a lower personal tax cost
- Does not trigger CPP premiums if these are not desirable
- Does not require the individual to be active in operations, only to merely hold equity in the corporation

Costs

- Not deductible to corporation
- Requires annual T5 reporting
- Does not generate CPP contributions or RRSP contribution room

While most of these methods are relatively straightforward calculations of the efforts or property provided to the corporation, it is important to understand that some of these methods actually reduce the amount invested in the corporation. For example, dividends can be based on a percentage or specified dollar amount and are arguably similar to interest paid on debt owed to the individual by the corporation; however, share redemptions, although treated for tax purposes similarly to dividends, actually reduce the investment the shareholder has in the farming corporation as a return of capital.

In cases where an individual wishes to preserve equity or investment in the corporation for retirement or passing on to the next generation, it is important to determine which method is the best fit in the long-term. Since there are numerous forms of compensation that an individual might have with a farming corporation it is suggested that consideration be given to discussing the best approach for them and their families with tax advisors.

Should you have any questions or comments, please do not hesitate to contact your Collins Barrow advisor for further assistance.

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