



Canadian Tax Planner

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YEAR-END REMUNERATION AND COVID-19 ISSUES

As we approach the end of the year, many owner-managers are considering the most efficient compensation strategy. While the flow through tax cost of a dividend or salary should be considered, there are a number of other issues to factor, many of which have greater importance in periods of tough economic times. In this issue we will discuss a number of these factors related to economic uncertainty.

We will also provide an update related to other employee remuneration issues which have arisen as a result of the COVID-19 pandemic.

Portions of this article were first published by the Canadian Tax Foundation in the Virtual Conference entitled 'A Definitive Guide to Owner Manager Taxation' (Toronto: Canadian Tax Foundation, 2020), authored by Video Tax News, and presented on September 22, 2020.

Specifically, we will discuss:

- PART 1: The Dividend vs. Salary Decision – Integration
- PART 2: The Dividend vs. Salary Decision – Economic Uncertainty Considerations
- PART 3: Update on Other COVID-19 Related Remuneration Issues

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PART 1: The Dividend vs. Salary Decision – Integration

The Canadian tax system is intended to be indifferent as to whether an individual earns income directly, or through a corporation and then distributed as a dividend. This is referred to as integration. However, integration is not perfect. The overall tax rate varies between the two routes because the system does not fully incorporate a number of issues, such as: the variety of corporate tax rates, tax rate changes if the personal tax on dividends and corporate tax is paid in different years, the variety of personal income tax brackets, the differences across the country in provincial/territorial personal and corporate taxation, and policy decisions (for example, a provincial government may choose, in some cases, to abandon the principle of integration). The variance in overall tax rate will be referred to as the “flow through tax cost/savings”.

That said, income eligible for the federal small business deduction (SBD) rates do not generally have a flow through cost greater than 1% across the country at the top marginal rates. This does not vary significantly when compared to calculations at lower marginal brackets. This means that factors outside of pure integration calculations will be required to make owner/manager remuneration decisions.

Beyond the flow through tax cost/savings, consideration should also be given to deferral possibilities. This is essentially the difference between the lower corporate tax and the higher personal tax which would be payable on the same amount. This deferral allows the incremental personal tax dollars to be used to generate income in the corporation until the funds are withdrawn for personal use. The government accepts, and occasionally even promotes, this deferral on active business income to allow corporations to reinvest in their business operations, contributing to growth in the economy and employment opportunities for Canadians. However, they are less accommodating of growth in the business owner’s investment portfolio, restricting the deferral by imposing increased taxes on such investment earnings within a corporation.

From a deferral perspective, opportunities are large, and have been increasing. This is partially due to a general trend across the country over the past decade to increase top personal tax rates, but decrease corporate rates, especially the SBD rate.

PART 2: The Dividend vs. Salary Decision – Economic Uncertainty Considerations

Other than integration, there are several other factors that must be considered from both a quantitative and qualitative perspective. This section will focus on considerations that are more relevant in times of economic uncertainty.

Risk of business failure

If there is a higher risk of business failure, the way in which a shareholder is remunerated could expose them to liability or additional tax.

Personal liability for corporate tax debt

Where a person receives assets (including dividends, but not salaries) from a non-arm’s length person (such as the corporation they control) that owes taxes, the recipient can become jointly and severally liable for the transferor’s tax debts. This liability is limited to the excess of the fair market value of the property received over the consideration provided for the property (which would be \$0 in the case of a dividend). As such,

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where the corporation has a tax debt at the same time as declaring a dividend, if the corporation does not satisfy its tax obligation, CRA may come after the dividend recipient to collect the corporation's tax debt.

Caution! This provision can be applied even if the recipient is unaware of the transferor's tax debt. Further, it can also be applied where, at the time of the transfer, it was believed that there was no tax debt, however, at a later point CRA reassesses to include income for that period.

Unusable losses

Unusable losses may be generated if salary is taken and there is no expectation of positive earnings against which it can be deducted. This will effectively mean that personal tax will be paid without the benefit of a corporate tax reduction. Paying a dividend will at least subject the shareholder to a lower personal tax rate.

Corporate law – Can I declare a dividend?

The ability to pay a dividend is a function of the governing corporate law, which generally turns on whether it hampers corporate liquidity, and whether it restricts other shareholders' rights. Dividend payments which violate corporate law could expose the shareholder to other liability outside of the tax context.

Employment-related expenses

A number of deductions which may be claimed on a personal tax return can be deducted against salary but not dividend income. As such, where these costs are incurred, at least some reasonable salary is needed or the potential deductions will be lost.

Home office and related expenses

Many individuals have found themselves working from home this year. This may mean that they can deduct related costs incurred. Also, many individuals may have used their personal vehicle to deliver product as retail and restaurant locations were intermittently closed due to public health orders. Some vehicle costs may also be deductible. Costs of this nature cannot generally be claimed against dividend income, but they can be deducted against employment income if certain conditions are met. In order to take advantage of these deductions, salaries, as opposed to dividends, may be required.

The employer may also provide support in various forms such as reimbursements, allowances, or rent-like payments. Of course, if these costs are reimbursed by the corporation, there would be no personal deduction.

Moving expenses

As industries react, some individuals may be forced to relocate. Moving costs may be incurred. While it is possible for employers to reimburse for such costs on a tax-free basis, some individuals may bear these costs personally. In such cases, the costs cannot offset dividend income. Moving expenses can offset employment income earned in the new location.

Child care costs

Child care costs may have increased due to school closures or preference to keep children out of schools. Among other requirements, child care expenses can offset earned income including salaries, but not dividends.

Low tax bracket benefits and credits

If the taxpayer has no other income, or is in a low tax bracket, earning a small salary could increase credits and benefits, while earning too much could erode them. In other words, having at least some

salary may enable the individual to take advantage of some credits and benefits.

In particular:

- The maximum Canada employment tax credit is obtained once an individual receives \$1,245 in employment income (for 2020).
- The Canada Workers Benefit is maximized once working income (including salaries but not dividends) reaches about \$9,000 and begins to decline at a 12% rate at approximately \$13,000 of net income (which includes salaries, dividends, and other income). Actual dollar figures vary by province/territory.
- Refundable medical credits are available to some low-income individuals who have earned income (which includes salaries but not dividends).
- Dividend tax credits may be wasted. When income levels are too low, the dividend tax credits may not be able to be fully utilized, meaning that the taxpayer will not receive full credit for the corporate tax paid. This can result in an overall higher amount of tax paid between the corporation and individual.

Retirement planning

Canada Pension Plan (CPP)

Given the significant fluctuations in the economy, taxpayers may be more inclined to invest in the CPP system rather than investing directly or through a savings account. An individual must have employment earnings in order to participate. In general, increasing pensionable earnings (up to \$58,700 for 2020) will increase future CPP entitlements. Note that future payments are based on average earnings throughout an individual's working life and at least the eight years of lowest earnings will be excluded. Therefore, pensionable earnings for a year will not increase payouts if they will end up being one of an individual's eight lowest years.

There is, however, a cost. For 2020, the rate is 5.25% for each of the employer and employee on the first \$58,700 of pensionable earnings (less the \$3,500 basic exemption amount). Rates and maximum pensionable amounts are scheduled to increase annually through to 2025.

RRSP and Individual Pension Plan

If an individual would like to save for retirement by using an RRSP or individual pension plan, contribution room is required. Contribution room is generated by salaries, not by dividends.

As income levels drop for 2020, deductions for RRSPs may not be as necessary or impactful. Therefore, if an individual continually takes salary to create contribution room, it may not be as essential this year.

Involvement in the business

The taxpayer's level and type of involvement in the business will dictate whether, and to what extent, they are at risk of having negative tax consequences assessed for things like non-taxable allowances and personal services business. The remuneration method chosen may support the taxpayer's position, or reduce exposure, in cases of an adverse CRA assessment.

Non-taxable benefits and allowances

Non-taxable benefits and allowances (such as participation in a private health services plan or the receipt of non-accountable reasonable travel allowances) are available if received in the individual's capacity as an employee. Essentially, the question is "Did you receive the benefit/allowance because you were an employee, or because you were a shareholder?" Although an individual could be an employee on an unpaid basis, receiving salary provides further support that the individual was an employee, and thus the benefits were received in an employment capacity. This may become more important as COVID-19 related benefits and supports are provided by employers.

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Personal services business (PSB) classification

PSB classification can significantly increase the overall corporate tax costs. Consider an individual who set up their own corporation and provides services to a third party through it. They may be conducting a PSB if they would otherwise appear to be an employee of that third party. As businesses shed staff and lose clients, they may find themselves only employing the owner who provides services for a few, or just a single client. These situations may put the corporation at higher risk of being considered a PSB.

The payment of salary reduces the level of corporate income that is exposed to these overall higher corporate tax rates. If there is a chance of reclassification to a PSB, and only dividends have been taken, the corporation would be subject to the higher tax rate on all income if reassessed.

Given the negligible flow through savings/cost of receiving salaries rather than dividends, taking drawings as salaries rather than dividends is a relatively low-cost strategy for reducing the impact if the taxpayer were later perceived as carrying on a PSB.

Payroll/health tax

The payroll/health tax in British Columbia, Manitoba, Ontario, Quebec and Newfoundland and Labrador are assessed on employment income, but not dividends. Salaries may subject the corporation to these taxes. However, there are exemptions where payroll is lower than certain thresholds. Although an employer may have been subject to these taxes in previous years, downsizing of staff may move the employer below the taxable threshold so they may now find that salaries can be paid without triggering the tax.

While these payroll costs can vary across the provinces, they can become quite expensive in all impacted provinces. With the state of provincial finances as we emerge from the COVID-19 pandemic, these rates may increase, and other provinces may consider similar taxes.

British Columbia

The employer health tax (EHT) in British Columbia starts at 2.925% of payroll between \$500,000 and \$1,500,000, and is calculated at 1.95% of the total payroll if it is greater than \$1,500,000.

Manitoba

The Manitoba Health and Post Secondary Education Tax Levy starts at 4.3% of payroll between \$1,250,000 and \$2,500,000, and is calculated at 2.15% of the total payroll if it is greater than \$2,500,000.

Ontario

The employer health tax (EHT) in Ontario starts at 0.98% on the first dollar of payroll in excess of the \$490,000 exemption. It peaks at 1.95% for every dollar that is in excess of \$400,000 above the exemption. Due to COVID-19, the exemption for 2020 has been increased to \$1,000,000.

Quebec

The Quebec Health Fund contribution rate is a more complicated calculation based on the entity's activities and payroll level, but generally ranges from 1.25% to 4.26% of payroll.

Newfoundland and Labrador

The Newfoundland and Labrador Health and Post Secondary Education Tax is 2% of remuneration paid in excess of the \$1,300,000 exemption threshold.

Other considerations

Government benefits and support

Government benefits and supports (either current or potential), may be dependent on payroll. For example, eligibility and level of support under the Canada Emergency Wage Subsidy (CEWS), and the "payroll stream" option under the Canada Emergency Business Account (CEBA) are dependent on payroll. Given that there has been a recent trend towards supporting employment,

paying salary may not only assist with current support applications, but also with future programs.

Mortgage and loan applications

As cash flow becomes tighter for Canadian families, the need to mortgage or re-mortgage may increase. Improved success and rates can often be obtained where a consistent level of salary is demonstrated.

Timing and level of remuneration

As indicated previously, one of the most significant advantages of using a corporation for income generating operations is the opportunity to defer and time the personal income tax inclusions. When determining how much income should be taken, consider the following:

- **Use of lower marginal tax brackets** is important to our progressive income tax system. Receiving and reporting income in a low-income year (such as during the COVID-19 pandemic) allows the accumulation of a shareholder loan balance to be drawn in lieu of higher personal income in a higher income year. At very low income levels, it is even more important to ensure that personal tax credits (both federal and provincial) are not wasted.
- **Canada child benefit (CCB)** is dependent on the number of children, their ages, and family income. Since dividends are grossed up, net income will be higher, therefore there will be a greater grind to the CCB (however, this may be negligible if comparing it to the level of salary that would be required to leave the shareholder in the same position). On the other hand, retaining cash in the corporation and paying particular attention to the timing of dividends could result in lower income levels for particular years, thereby enabling greater CCB.
- **OAS** is reduced by 15% of each dollar of net income in excess of certain thresholds (\$79,054 for the 2020 tax year). Dividends inflate net income more than salaries due to

the gross-up. However, being able to retain income in the corporation to reduce grinds to OAS will garner a 15% claw back reduction. Seniors with very low income will generally see their eligibility for the Guaranteed Income Supplement eroded with every dollar of additional income. Many provincial/territorial benefits for seniors are also income-tested.

- **Employment insurance** benefits must be partially repaid where net income exceeds 125% of maximum yearly insurable earnings ($\$54,200 \times 1.25 = \$67,750$ for 2020).
- The **Canada recovery benefit** must be repaid at 50 cents for every dollar of income in excess of \$38,000 for the calendar year (this will only impact 2020 and 2021 based on current proposals).
- **Various other personal costs** depend on the personal tax return income level, such as municipal facility/transit passes, and nursing home/care home fees.
- **Expected tax rate changes** can cause an inflated tax bill or create a planning opportunity. For example, if an individual thinks (or knows) that personal rates will be changing in the subsequent year (as we did, for example, in late 2015), the individual can time the payment depending on preference. Further, the flexibility of being able to time when amounts are paid out of the corporation provides more opportunity for smoothing income such that lower marginal tax brackets are fully utilized. Similar planning can be undertaken when dividend tax credits will change in a future year.

Strategy – Taking at least a minimum salary

One strategy that is being more commonly used is taking at least a minimal salary, and then choosing whether the remainder should be taken as a dividend or salary. Taking at least a minimal salary achieves the goals of many of the above factors that encourage salaries, while at the same time giving the opportunity to take advantage of

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dividends. For example, taking a salary of at least \$6,000 enables the employment tax credit claim, allows for some child care/moving deductions, and entitles the individual to the insurance of CPP disability benefit, while only costing nominal CPP (given that there is a \$3,500 exemption).

Taking a regular salary to cover personal living expenses, and remitting regular source deductions, also reduces the stress which often accompanies the requirement to deal with significant drawings at the time of year-end financial statement and tax return preparation.

PART 3: Update on Other COVID-19 Related Remuneration Issues

As we move forward during this pandemic, a number of remuneration issues and possibilities, beyond simply the salary or dividend determination, have come up. Many are specific to the COVID-19 pandemic and will be discussed here. See Canadian Tax Planner May 2020 for additional possibilities such as the Employment Insurance Work-Sharing Program and the various COVID-19 specific programs, including the Canada Emergency Wage Subsidy and the 10% Temporary Wage Subsidy. See also Canadian Tax Planner September 2020 for a more detailed discussion of the Canada Emergency Wage Subsidy.

Telecommuting Allowances and Reimbursements

As more individuals are working from home, employees may be incurring more costs to set up their home office.

In a recent communication, CRA was asked whether amounts paid to an employee for costs of equipment for working remotely would be a taxable benefit. CRA first noted that a non-accountable allowance would always be taxable, as there is no provision that would allow the amount to be non-taxable.

However, CRA noted that, in the context of the COVID-19 pandemic, the acquisition of computer equipment, a chair, a desk, or monitors, to enable the employee to carry out their duties at home, may be primarily for the employer's benefit. In that context, CRA stated that they are prepared to accept a non-taxable reimbursement to the

employee, supported by actual invoices or receipts, of up to \$500 towards such equipment.

Tip! Care should be afforded when compensating individuals for setting up a work space in the home. For the amount to be non-taxable, the employee must provide receipts for equipment for which they require a reimbursement. A flat allowance is taxable.

In this communication, CRA did not comment on situations in which the equipment was used exclusively for employment purposes and was owned by the employer as opposed to the employee. CRA has indicated in the past that, where equipment is property of the employer, and any personal use is incidental, there would be no taxable benefit to the employee.

Where taxable allowances are provided, the employee may deduct the associated costs of supplies (capital costs, such as CCA is not deductible) as long as they are permitted by a validly issued T2200 from the employer. For example, assume that the employer provided a \$200/month allowance for paper and other supplies, but did not require receipts. The amount would be required to be included in income. Assume that \$150 were spent on such supplies used in the course of employment. As long as the T2200 was correct and indicated that the employee was required to pay for such supplies, the amounts would be deductible.

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Health Care Spending Accounts (HCSA)

An HCSA is a type of private health services plan (PHSP) which allows employers to provide non-taxable health benefits to their employees, while still maintaining a deduction in the business. While some HCSAs do not allow the unreimbursed eligible medical expenses or credits to be carried forward, some do allow a carryforward for a period not exceeding 12 months. However, due to the restrictions placed on many services during the COVID-19 pandemic, members may not be able to use the credits before they expire.

In a recent communication, CRA stated that an HCSA (which qualifies as a PHSP) which has unused credits expiring between March 15 and December 31, 2020 may temporarily permit an extended carryforward period without loss of PHSP status. The extended period must be reasonable to permit plan members to access services that were restricted during the COVID-19 pandemic. A period of up to six months would generally be considered reasonable in this regard.

Leave of Absence – Salary Deferral

A salary deferral arrangement (SDA) is a plan where a person has a right to receive an amount in a future year in respect of salary, wages or services rendered by the person in the year or preceding year and where one of the main purposes of the plan is to defer tax. In this case, the deferred amount is included in income for the year in which the future right is acquired and not when the amount is actually received in the future.

An exception to the above rule is a deferred salary leave plan where an employee may defer salary to fund a leave of absence (LOA) from employment. The deferred amount is taxed when actually received. To qualify, various conditions must be satisfied including that:

- the plan is not established to provide post-retirement benefits;
- the plan is established for the purpose of funding a LOA through salary deferrals; and

- the LOA will be for a period of at least six consecutive months (reduced to three months if taken for the purpose of full-time post-secondary education).

Historically, the LOA was required to commence immediately after a period of no more than six years after the date on which deferrals of salary commence. However, due to the COVID-19 pandemic relieving measures were provided. On July 2, 2020, the Department of Finance released regulations which would extend the six-year period, in respect of an arrangement that would end on or after March 15, 2020 and on or before April 30, 2021, to be 86 months (7 years and 2 months).

In a separate communication, CRA noted that this relieving measure will provide flexibility for health care workers, other essential service workers, and employees who planned to use their LOA to travel but cannot due to travel restrictions.

Contributions to Employee's Crowdfunding Campaign

As some individuals struggle financially due to medical issues, a job loss, or business struggles/failures, arising from the COVID-19 pandemic, some may try to assist by raising funds through an online crowdfunding campaign.

In a recent communication, CRA considered whether an employer's contribution to their employee's crowdfunding campaign would be received in the recipient's capacity as an employee (taxable) or individual (not taxable).

Where the person is dealing at arm's length with the employer and is not a person of influence (such as an executive who controls employer decisions), CRA indicated that the amount would generally be received in the person's capacity as an individual (not taxable) where the amount is:

- provided for humanitarian or philanthropic reasons;
- provided voluntarily;

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- not based on employment factors such as performance, position, or years of service; and
- not provided in exchange for employment services.

Additional factors CRA may consider include whether:

- the individual was affected by extenuating circumstances or an event (outside of work) that was beyond their control (e.g., serious illness or injury of the individual or a family member, disaster, funeral expenses);
- the contribution was based on compassionate grounds and was meant to provide short-term financial assistance to compensate the individual for personal losses or damage suffered, increased living costs incurred as a result of the extenuating circumstances or event, or to cover the basic necessities of life;
- the contribution was received as a one-time lump sum amount;
- the employer had a reasonable expectation that the contribution would be spent within a reasonable amount of time and on items or expenses arising from the extenuating circumstances or event or on the basic necessities of life;
- the value of the contribution was reasonable and was made within a reasonable period of time following the extenuating circumstances or event; and
- the contribution was not meant to compensate for loss of income and is not subject to any conditions tied to the individual's employment.

Where the contribution represents a disguised form of remuneration, it would be taxable employment income.

Supplemental Unemployment Benefits (SUB)

A SUB plan allows an employer to make supplemental payments to Employment Insurance (EI) benefits, without eroding those EI benefits. As payments under a registered SUB plan are not insurable earnings, EI premiums are not deducted. As many individuals have recently transitioned from the Canada Emergency Response Benefit (CERB) which was eliminated if too much income (including SUB payments) was received, to the EI program, the importance of these plans has increased.

To be eligible, SUB plans must be registered with Service Canada before their effective date and must:

- identify the group of employees covered and the duration of the plan;
- cover a period of unemployment caused by one or a combination of the following:
 - temporary stoppage of work,
 - training,
 - illness, injury or quarantine;
- require employees to apply for and be in receipt of EI benefits in order to receive payments under the plan;
- require that the combined weekly payments from the plan and the portion of the EI weekly benefit rate does not exceed 95% of the employee's normal weekly earnings;
- require the plan be entirely financed by the employer;
- require that on termination all remaining assets of the plan will revert to the employer or be used for payments under the plan or for its administrative costs;

- require that written notice of any change to the plan be given to Service Canada within 30 days after the effective date of the change;
- provide that the employees have no vested right to payments under the plan except during a period of unemployment specified in the plan; and
- provide that payments in respect of guaranteed annual remuneration, deferred remuneration, or severance pay will not be reduced or increased by payments received under the plan.

A plan registered with Service Canada is not required to be a trust. It could be funded from general revenues.

For income tax purposes, a SUB plan is defined more restrictively, as it is required to be a trust to which the employer makes payments. Such plans can be registered with CRA, in which case any income earned within the SUB trust is non-taxable. Whether or not registered, receipts are taxable to the employee. Payments to a registered SUB plan are deductible to the employer if made no later than 30 days after year-end. Payments to SUB plans are not otherwise deductible, so a plan structured as a trust must be registered for employer contributions to be deductible.

A SUB plan which is not a trust would not be subject to the above tax rules. Deductibility of payments would follow the general rules for all expenses for income tax purposes.

CONCLUSION

As the end of the year approaches, decisions need to be made as to compensation for owner-managers and other employees. For owner-managers, factors beyond the flow through tax cost/saving should be considered, especially as some of these issues become more important as the economy struggles. In respect of other employee remuneration issues, the COVID-19 pandemic has brought challenges and opportunities to rethink basic and other more unique structures.

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