THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Understand the nuances of paying your family salary before year-end

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An important lesson I learned earlier in life is that having one child made me a parent. Having three children made me a referee. Then my kids became teenagers. "Dad, since I lack any type of important life experience, I have decided to follow your advice" – said no teenager to me ever. But I love them just the same. Finally, my kids became old enough that I could start to involve them in my tax planning by paying them salaries from my business, along with salary to my wife, Carolyn. Today, I want to talk about the nuances of paying family members salary to save tax – because there's more to it than meets the eye.

Let me start by saying, if you're a business owner, paying salary or wages to your spouse or kids (or any family member, for that matter) before Dec. 31 will provide a deduction against your business income in 2021, which will save your family tax as long as that person is in a lower tax bracket than you.

Your family members can earn as much as $13,808 in 2021 (this is the basic personal amount for those in the lowest tax bracket) before having to pay any federal tax. When you add other tax credits into the picture, such as tuition tax credits, many young people could earn up to about $20,000 in 2021 before paying any taxes. Now, here are some things to keep in mind.

You'll create RRSP room. In addition to getting a tax deduction for salaries or wages paid, your spouse or kids who receive the compensation will have earned income, which provides RRSP contribution room. This will save them more tax when they contribute to an RRSP and will help them save for the future.

Make sure they do some work. If the Canada Revenue Agency (CRA) comes knocking to ask questions about salary or wages paid to your spouse or kids, you can be sure you'll be asked to provide a job description, along with a log of specific dates and times the work was performed. So, keep these details. I know of one business owner that was audited and the auditor asked an employee of the business, "Do you ever see your boss's wife around the shop?" The answer was: "Never." That's not good. The deduction for salary was denied. I suggest that if you're going to pay your spouse to work in the business, your employees had better be able to identify your spouse in a lineup of people (I'm kidding, of course – just make sure your spouse actually does some work).

Pay only reasonable amounts. Section 67 of our tax law will allow expenses to be deducted only if they're reasonable. What's reasonable when it comes to salary or wages? The taxman will consider what you would have paid to an unrelated third party for the same work. If you pay an unreasonably high salary or wage, the full deduction could be denied. And here's the crazy thing: Your family member could still end up paying tax on the compensation even though your business is not allowed a deduction. That's double taxation on the amount. Not good.

Make the payments real. In the court case Muhammedi v. R. (2004 TCC 408), the taxpayer deducted $12,500 and $3,500 for 1999 and 2000, respectively, as casual labour expenses for work done by his spouse and children. Although cheques were written for work done by the kids, they were deposited back into the bank account of the business, or the owner, or his spouse. The judge disallowed the deductions because the funds remained under the control of the parents or the business, rather than the children who earned the money. In a June 10, 2021, court decision, Prunoiu v. QRA (2021 QCCQ 7555), the salary deductions were denied because there was no proof the amounts were actually paid to the family members. So, make sure there's evidence of payment.

You can pay wages in kind. Paying salary or wages by cheque or electronic money transfer is easiest to record and track. But in the case of Aprile v. R (2005 TCC 216), the taxpayer paid children $14,000 to help in the business. He paid them partly by buying them snowmobiles, motorcycles and gas for those machines. The judge ruled this was a legitimate form of compensation. Complicated – but legitimate.

You may avoid EI premiums. When you pay family members to work in your business, the work may be "excluded employment," which means they may not be able to collect employment insurance later if they tried, and also means you and your family members may not need to pay EI premiums. Speak to an accountant to confirm if the employment is indeed excluded employment.

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