Who owns your company?

Allocate shares with care

Tax Talk

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For a lot of owner/operators, the "operator" side of the business is straightforward enough. But you can never take the "owner" part for granted, even when your boardroom table doubles as the kitchen table.

Like any company listed in the stock tables of the newspaper, your corporation is collectively owned by its shareholders. Shareholders elect directors (who hire the president, secretary, and treasurer) and can be paid dividends when the company earns a profit. They also have a right to the company's assets should it be liquidated.

Many owner/operators hold 100% of the shares in their company. Others issue shares to their spouse because he or she is employed by the business in some way. Some give shares to a spouse as part of a tax strategy.

They want to lower their individual tax obligation by splitting income, for example.

How to allocate your corporation's shares is a decision you need to take seriously. Because let me tell you, the government sure does.

I know an owner/operator who asked a lawyer to incorporate his business for him.

The lawyer gave the owner/operator one share and his wife one share for no reason other than that's just the way the lawyer did all his clients. The wife had a full-time job and played no active role in the company.

Fast-forward a few years. The trucking business is going well but the wife gets laid off when her employer ceases operation. She submits an application for Employment Insurance benefits.

When you file an EI claim, Human Resources and Social Development Canada (HRSDC) will review your total earnings during the 26 weeks leading up to your last day of work. This includes any income you receive as an officer of a corporation.

When HRSDC searched its databases and saw that the wife was a 50% shareholder and officer of her husband's trucking company, it determined that she was self-employed and clawed back the wife's percentage of the corporation's weekly earnings from her benefit claims.

HRSDC sees plenty of scams where a corporation earns income while a principal shareholder does not and files an EI claim.

But in this case, the wife hadn't taken a dime from the business and, having paid into the system all these years, simply wanted the benefits she felt entitled to after she lost her job.

Yet HRSDC decided to "pierce the corporate veil," attach a portion of the company's earnings to her overall income, and adjust the EI claim accordingly. (This owner/operator and his wife happened to be incorporated, but the same thing could happen in a sole proprietorship or partnership. Do you really want your spouses's name attached as an owner?)

How do you insulate yourself from this kind of scenario yet preserve the potential tax benefits of income splitting?

When we set up corporations, we want to allocate shares in a way that makes sense for the business and its owners today and down the road. If the spouse is not active in the company, we might allocate 1,000 shares to the owner/operator and 10 to the spouse. At only 1%, the share is such a small portion that the exposure to an HRSDC EI claim-adjustment is minimal. Yet as a shareholder, the spouse can receive dividends on a fixed schedule or a special dividend at any time.

There are other important things to consider when allocating shares to a spouse:

1) What if you divorce or one of you dies? The shares in the company have value. Would you or your spouse be able to buy the remaining shares?

2) What are you trying to hide? That's the question Canada Revenue Agency, HRSDC, and your spouse's divorce attorney will ask if your company is flush with cash but your personal income is low. When someone says that his wife owns the business even though she has nothing to do with running it, you have to wonder if he's hiding income or assets from an ex-spouse or collection agency.

3) Get professional help. If your spouse is a vital part of the company, maybe he or she should own half or a significant piece of it. Maybe you're only distributing shares for tax planning. Either way, talk to someone with the experience to see the range of possibilities and pitfalls of your options.

Incorporating your business is a big decision, but in fact incorporation involves a series of choices starting with how to allocate shares in the company.

Even if you're a sole proprietor or involved in a partnership, talk to your accountant or business advisor about how you, your spouse, and your company are affected when your spouse is listed as an owner in the business.

After all, the "owner" part of the owner/operator's business comes first. Don't overlook this critical step. □

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