Are Profit Sharing Allocations Subject to Source Deductions?



Under Employee Profit Sharing Plans (EPSPs), employers contribute a portion of profits to an EPSP trust on behalf of their employees. EPSP trustees then allocate amounts received, plus any other income from trust investments to employees. Neither employer contributions to the trust nor payments out of the trust to employees are subject to source deductions for income tax, CPP, or EI. Employees must include amounts allocated to them by EPSP trustees as taxable income on their tax returns.

By contrast, employees aren't required to self-assess for either CPP or EI (after all, source deduction is the only mechanism for paying CPP contributions and EI premiums.) This creates the potential for abuse. Small business employers may route their own earnings, as well as wages and salaries owed to employees, through EPSPs to avoid source deductions (although income tax must ultimately be paid). However, courts won't allow this if they think the EPSP is a sham to get around source deductions. Here's a case that illustrates how courts determine if an EPSP is bona fide or a sham.

EPSP Is a Sham & Payments Are Subject to Source Deductions

Situation: A small insurance brokerage sets up an EPSP on behalf of 3 employees and the president of the company who owns the business. For the tax years 2006, 2007, and 2008, the brokerage pays what had previously been bi-weekly salary and wages to the 3 employees into the EPSP trust instead. All amounts the employer pays into the EPSP trust are paid out of the trust on receipt. Source deductions are made on none of the payments into or out of the trust. Following a payroll audit of the EPSP, the CRA assesses the employer for CPP contributions and EI premiums. The employer appeals.

Ruling: The Tax Court denies the appeal.

Reasoning: The EPSP trust documents state that the purpose of the EPSP trust is to allow employees to share in the profits of the business and that employer contributions are discretionary. The Court noted that the 3 employees received virtually all of their regular salary and wages via payments from the EPSP trust. Regular salary and wages are, by definition, not part of a business's profits. And because employees had to get paid, the payments weren't discretionary. So, the Court found that the EPSP was established on a deceitful basis. The bi-weekly EPSP payments

were thus just a sham to shield salary from source deductions. Accordingly, the court upheld the CRA assessments on the payments.

J.R. Saint & Associates Insurance Agencies Ltd. v. Canada (M.N.R.), 2010 TCC 168 (CanLII)

EPSP Is Not a Sham & Payments Are Not Subject to Source Deductions

Situation: The finding that the bi-weekly EPSP payments were a sham is just part of the *JR Saint* case. That same small insurance broker also makes lump sum payments into that same EPSP on behalf of those same 3 employees receiving bi-weekly payments, as well as the company president who owns the business. Again, all amounts paid by the employer into the EPSP trust are paid out of the trust on receipt. Once more, no source deductions are made on any of the lump-sum payments into or out of the trust. And, once again, CRA assesses CPP and EI on the payments and the employer appeals.

Ruling: This time the Tax Court strikes down the assessments.

Reasoning: The Court noted that the business owner was in a position to take his profits from the business as dividends paid on the shares he owned in the company or as wages for his services. Instead, he took them as contributions on his behalf to the EPSP. Such payments represented bona fide profits of the business. And unlike the bi-weekly salary payments, the lump-sums paid to the 3 employees truly were made at the owner’s discretion. Accordingly, the Court ruled that the arrangement, with regard to the lump-sum payment, was not a sham and that the payments weren’t subject to CPP and EI source deductions.