

DISCUSSION PAPER

1. TITLE

Inclusion of Principals' Dividends in Assessable Payroll

2. ISSUE

Principals of some companies do not pay themselves for labour through the company's payroll. Instead, they take dividends from the company's profits as payment for their labour.

Policy provides that WorkSafeBC ("WCB") may include dividends in assessable payroll where they represent payment for services provided by active principals. However, it is difficult to determine what portion of dividends represents payment for a principal's activity in a company, and policy provides no guidance on how to do so.

The Workers' Compensation Appeal Tribunal ("WCAT") has also criticized the Assessment Department's current practice on assessing dividends as being inconsistent with policy.

At issue is whether to assess dividends, and if so, how to include them in assessable payroll.

3. BACKGROUND

3.1 Law and Policy

The *Workers Compensation Act* ("Act") provides the WCB with the authority to assess, levy on and collect assessments from employers in any manner the WCB considers proper to fund the workers' compensation system.¹ Based on that authority, the WCB can develop assessment policies that may be applied in a practical way to ensure that enough assessments are collected to meet the Act's objectives.

The Act sets out that when calculating payroll amounts for the purpose of assessment, regard must be had only to the portion of payroll that represents workers.² According to assessment policy, active principals, shareholders, directors, or officers of a corporation are generally considered to be workers.³

¹ Sections 38 and 39 of the Act.

² Section 38 of the Act.

³ Item AP1-1-4, *Coverage under Act – Employers in the Assessment Manual*.

Assessment policy also provides that dividends paid to principals may be considered as part of assessable payroll if paid for activity in a company.⁴ The policy requires an evaluation of a principal's level of activity in the company when assessing dividends. The purpose of this policy is to assess on a principal's earnings as a worker.

Compensation policy provides that when a principal's average earnings are determined for a claim, the WCB may consider dividends as earnings in cases where the amount received by the principal represents payment for the principal's labour.⁵ This reflects the policy language in the *Assessment Manual*.

3.2 Assessment Practice

If a principal is an active worker in a firm, the practice is to assess a principal's dividends as reported on a T5 form only when they are higher than the principal's reported T4 and T4A earnings.⁶ In these cases, firms are assessed on the combined T4, T4A and T5 amounts up to the maximum assessable earnings for the year.

If a principal is not an active worker in the firm, dividends are not included in assessable payroll. As well, active principals' dividends are not included if they are lower than earnings as reported in a T4 and T4A form.

The Assessment Department advises that the practice is easy for employers to understand and for the WCB to administer. The practice is widely published to employers. It is included in a brochure enclosed with the payroll reporting forms sent to employers, and is also published on the WorkSafeBC website.

WCB payroll reporting forms require firms to report all payroll as a lump sum, so information concerning dividends is not required to be reported separately. As a result, the issue of dividends is generally not considered until there is an audit.

If an audit is carried out, and it is found that a principal has received dividends, an assessment officer first determines whether the principal was active in the firm. The Assessment Department uses several criteria to determine whether a principal was active, including:

- the amount of time that the principal spends working for the firm;
- whether the principal has the authority to sign cheques on behalf of the firm;
- whether the principal has strategic decision-making responsibilities;
- whether the principal attends Director meetings; and

⁴ Item AP1-38-2, *Payroll – Categories in the Assessment Manual*.

⁵ Policy item #68.90, *Principals – Composition of Earnings, Rehabilitation Services & Claims Manual*, Volume II.

⁶ T5 = Statement of Investment Income.

T4 = Statement of Remuneration.

T4A = Statement of Pension, Retirement, Annuity and Other Income.

- how much the principal takes as earnings.

If an audit discovers that a firm should have but did not include dividends in assessable payroll, an 8% under-remitting penalty applies. Currently, 60 to 70 percent of all audits result in penalties to firms for failing to submit complete and accurate payroll records. The Audit Section advises that it cannot estimate the number of penalties associated with the reporting of dividends.

3.3 Compensation Practice

Compensation practice is to include dividend income in average earnings where there is evidence that the dividends represent payment in exchange for services, activities or work performed for the company. Where there is evidence that a principal is an active worker in the company, generally that principal's dividends are included as earnings when setting compensation rates.

Worker and Employer Services ("WES") Division compensation staff look at several criteria to determine whether a dividend represents payment for labour. This includes the criteria used by the Assessment Department listed in the previous section as well as:

- determining whether the claim is the result of a principal's primary or secondary job;
- confirmation from a principal's accountant/bookkeeper regarding the actual dividend amount earned in the 12 months prior to the date of injury;
- determining whether a principal consistently receives a monthly or annual dividend regardless of the amount of work done.

Using the list above, compensation staff examine whether a principal is active in a firm. If it is found that a principal is active, generally the entire dividend amount is included in the calculation of average earnings.

The Wage Rate Unit of the WES Division estimates that it deals with approximately 450 cases per year which could potentially include principals' dividends.

3.4 Reviews and Appeals

Between 2006 and 2008, 84 Review Division decisions dealt with the assessment of earnings, which includes cases dealing with the inclusion of principals' dividends in assessable payroll.

Two WCAT decisions have specifically dealt with the inclusion of principals' dividends in assessable payroll since 2003.

4. DISCUSSION

4.1 WCAT Commentary

The WCAT has dealt with the inclusion of principals' dividends in assessable payroll in two decisions in recent years. In one decision it was noted that the current practice of including all dividend payments in assessable payroll when they exceed T4 and T4A amounts is not consistent with policy. This is because it fails to correlate the value of a principal's dividends with the value of the labour provided by the principal to the firm.

The Vice-Chair commented that the current practice is inconsistent with policy, in that it can result in the inclusion of dividends where a principal is active, without determining a principal's level of activity.⁷ The WCAT has interpreted the policy such that a principal's level of activity must be reflected in the dividends assessed by the WCB.

4.2 The Challenge of Assessing Dividends Based on Activity

There are challenges associated with assessing dividends based on a principal's level of activity in a firm.

The main challenge is determining to what extent a principal was active in a firm. This issue generally only arises in an audit. This decision is usually based on limited information, because audits are generally conducted several years after the company has reported. It is often difficult to ascertain how active a principal may have been in the firm during the audit period. Thus, it is currently difficult to ensure that dividends are being appropriately assessed.

The difficulty in obtaining information concerning the level of activity is the key reason why the Assessment Department adopted the practice of only assessing dividends where they exceed other earnings amounts.

In practice, employers are not asked to do an evaluation of principals' activity levels, so that dividends may be apportioned between profit and labour. Requiring employers to apportion dividends between labour and profit would mean considering the time a principal spends at work, a principal's financial investment in the company, the level of a principal's authority, and a principal's role in the company. Many other possible variables would also have to be considered.

4.3 The Relationship Between Assessment and Compensation Amounts

One issue under consideration in this policy review is the difference in how dividends are treated for assessment and compensation purposes. As noted previously,

⁷ WCAT Decision 2006-03798.

current practice promotes inclusion of dividends in compensation amounts, and only occasional inclusion of dividends in assessment amounts.

There is no express provision in the *Act* that requires assessment amounts to equal compensation amounts.⁸ However, differences between assessment and compensation amounts can be difficult to explain, raising questions concerning what earnings are assessable versus what earnings are compensable.

4.4 Other Possible Approaches

Given the challenges with current policy and practice as noted above, set out below are three possible approaches to address these challenges in assessing dividends.

4.4.1 Apportion Dividends Between Profit and Labour

The first approach could be to develop criteria to guide the determination of how dividends should be apportioned between profit and labour. The criteria could include those used by the Assessment Department and Compensation Services staff to evaluate a principal's level of activity in a firm. This would provide guidance to firms and the WCB as to how dividends should be assessed.

This approach would be time consuming and labour intensive for firms. It would be administratively challenging for the WCB to obtain and evaluate evidence concerning a principal's level of activity in a company. The WCB would also have difficulty in obtaining evidence and evaluating the dividends a firm reports as assessable payroll. Further, as this approach would be subject to interpretation, many differences of opinion could arise between firms and the WCB regarding the portion of dividends that represent payment for labour. Review and appeal volumes would likely increase as a result.

4.4.2 Assess Dividends Paid to Active Principals

A second approach could be to assess dividends paid to active principals in a company, regardless of activity level. As active principals are generally workers, this would be consistent with the guidance in the *Act* that payroll representing workers is assessable. This would be easier than requiring an apportionment of dividends based on activity, and would be less time consuming and labour intensive for firms in comparison to the previous approach.

This approach would prevent the assessment of dividends paid to principals who are not active in the firm. In addition, as the current practice of assessing dividends only where they exceed other payments would be discontinued, there would be less incentive for firms to structure payments to principals to avoid assessment.

⁸ See Appeal Division Decision #97-0870.

In terms of financial impact, this approach would increase assessable payroll amounts for some companies paying dividends. It is difficult to determine the volume of the increase, as dividends can vary significantly, and the WCB has not collected data on dividends in recent years.

4.4.3 Dividends Not Included in Assessable Payroll

A third possible approach could be to not assess dividends, which would be simpler for the WCB to administer. As active principals are generally workers, this would result in some workers' earnings not being included in assessable payroll.

It would result in lower premiums for many companies, and may provide an incentive for firms to declare more principals' earnings as dividends to lower assessable payroll.

5. OTHER JURISDICTIONS

The PRD reviewed how other Canadian workers' compensation jurisdictions treat principals' dividends for assessment and compensation purposes. Several Canadian jurisdictions have specific policies or practices that address the inclusion of principals' dividends in assessable payroll and compensation amounts.

However, legislation in seven other jurisdictions does not provide for automatic worker coverage for principals. Instead, if principals want coverage they are required to take out some form of optional coverage, similar to BC's Personal Optional Protection ("POP") for proprietors or partners.⁹ As a result, an analysis of these jurisdictions is not beneficial.

5.1 Assessment

The Yukon's *Workers Compensation Act* does not consider dividends to be earnings, so they are therefore not assessable. In practice, Saskatchewan and Nova Scotia do not include dividends in assessable payroll.

Ontario's policy is to include all dividends, "where executive officers of private corporations, with WSIB optional insurance, choose a remuneration package for themselves comprised of dividends."

According to Newfoundland's *Workplace Health, Safety and Compensation Act*, if a shareholder does not submit a reasonable sum of payment for services, the province may add what it considers to be reasonable earnings to the firm's payroll. In practice,

⁹ Alberta, Manitoba, Ontario, Quebec, Prince Edward Island, New Brunswick, and Northwest Territories and Nunavut.

this would include dividends if the shareholder is active in the firm.¹⁰ Dividends are included in assessable payroll for active shareholders up to the maximum assessable earnings for the year. If the shareholder receives a combination of dividends and other salary payments, the dividend would be used to top up the assessable earnings to the maximum compensable level.

5.2 Compensation

With respect to compensation, Saskatchewan and Nova Scotia do not include dividends in compensable earnings. In these jurisdictions, dividends are considered a return on investment rather than employment earnings.

Ontario's policy provides that executive officers' average earnings are calculated using either the amount of coverage purchased by the principal, or the actual employment earnings at the time of injury (including dividend income as reported in a T5 form), whichever is less.

Newfoundland's policy is to include dividends when calculating compensation rates, provided that the earnings loss period exceeds thirteen consecutive weeks, the dividends were paid prior to the beginning of earnings loss, and the dividends were assessable.

The Yukon's practice provides that dividends are compensable if they are paid like a bonus, appear on a paycheque, and are taxed.

6. OPTIONS AND IMPLICATIONS

For options 2, 3 and 4, minor changes would also be made to the policy. The changes include using consistent terminology when referring to principals and firms, and clarifying a reference to the maximum wage for assessment purposes.

Option 1: Status quo

Under this option, no change would be made to current policy concerning the assessment of principals' dividends.

Implications

- The Assessment Department would consider revising the current practice of assessing principals' dividends only when dividends as reported on a T5 are higher than a principal's payroll as reported on a T4 or T4A. This would address the concerns raised by the WCAT. If the current practice did not continue,

¹⁰ A shareholder's level of activity is determined by examining factors such as: involvement in day-to-day business; whether the shareholder is allocating workloads; and whether the shareholder is approving payments.

principals would be responsible for calculating and recording the portion of dividends representing payment for labour.

- Policy would not provide guidance on how to determine what portion of dividends represents payment for labour.
- If the current practice continued, assessment premiums would not always reflect the value of a principal's labour for a company. For example, principals who do little work for a company but collect large dividend payments could be over-assessed. As well, principals who do a lot of work for a company but collect dividend payments lower than T4 or T4A amounts could be under-assessed relative to principals who have assessable dividends.
- During audits, it would continue to be difficult for the WCB to obtain information on principals' dividends or activity, as information concerning dividends is not required to be reported separately on forms.

Option 2: Apportion Dividends Between Profit and Labour

Under this option:

- Assessment policy would set out criteria to guide firms and the WCB on how to determine the portion of dividends that represents payment for services to active principals, who are generally considered to be workers under the *Act*. The criteria used could include:
 - The amount of time that the principal spends working for the firm
 - Whether the principal has the authority to sign cheques on behalf of the firm
 - Whether the principal has strategic decision-making responsibilities
 - Whether the principal attends Director meetings
 - How much the principal takes as earnings
 - Whether the dividends are payable from a principal's primary or secondary job
 - Whether a principal consistently receives a monthly or annual dividend regardless of the amount of work done
- Policy would make firms responsible for calculating and recording the portion of dividends that represent payment for work.

Implications

- Firms would be responsible for calculating the portion of dividends representing payment for each principal's work, and it would be time consuming and labour intensive for firms to apportion dividend income representing a principal's level of activity.
- It would continue to be difficult for the WCB to both obtain information supporting the apportionment of dividends, and to verify whether a firm's apportionment of dividends is correct.

- It is possible that more dividends would be considered as assessable payroll. However, dividend information can vary significantly, and is only verified in audits. Therefore it is difficult to estimate how much in future dividends would be captured as assessable payroll under this option.
- Regardless of the criteria adopted, the apportionment of dividends between profit and labour would continue to be a judgement decision based on available information. As a result, reviews and appeals would possibly increase as the WCB and principals would disagree at times on the amount of dividends included in assessable payroll.
- Assessable payroll would more closely reflect the value of a principal's activities and earnings currently used to set wage rates on claims.
- This approach is consistent with the guidance in the *Act* that payroll representing workers is assessable.

Option 3: Assess Dividends Paid to Active Principals

Under this option policy would be amended to state that dividends paid to active principals, who are generally considered to be workers under the *Act*, are included in assessable payroll.

Draft policy amendments reflecting this option are attached as Appendix A.

Implications

- Dividends paid to active principals would be considered payment for labour. All T4, T4A and T5 amounts would be assessed up to the maximum wage established for that year.
- More dividends would be captured in assessable payroll, resulting in higher assessable payroll amounts for companies with active principals. It is difficult to determine the volume of the increase, as dividends can vary significantly, and the WCB has not collected data on dividends in recent years.
- The dividends of inactive principals would not be assessed.
- Reviews and appeals may possibly decrease given that firms would not be required to determine principals' level of activity in the firm.
- As the entire dividend amount would be included in assessable payroll, assessment practice would mirror compensation practice. For compensation purposes, dividend payments would continue to be included in average earnings.
- There would be less incentive for firms to structure payments to principals to avoid assessment.
- This approach is similar to Ontario's policy and Newfoundland's practice.
- This approach is consistent with the guidance in the *Act* that payroll representing earnings to workers is assessable.

Option 4: Dividends Not Included in Assessable Payroll

Under this option, policy would be amended to delete the reference to dividends being included in assessable payroll.

Implications

- A principal's T4 and T4A amounts would be assessed, up to the maximum wage established for that year. T5 amounts would not be assessed.
- In cases where a principal is active in a corporation, his or her dividend payments may comprise a significant source of income. The firm's assessments would not reflect these principals' activities.
- Companies that make significant payments to active principals would pay lower assessment premiums, and there may be an incentive for firms to declare more principals' earnings as dividends to lower assessable payroll.
- There would be no consideration of a principal's activity level in a firm, resulting in less confusion for stakeholders and Assessment Department and Audit Section staff.
- This approach would eliminate reviews and appeals concerning the assessment of dividends, as decisions concerning this issue would no longer be made.
- This would reflect the approach taken in most Canadian jurisdictions.
- Assessment practice concerning dividends would not mirror compensation practice.
- This approach could be considered inconsistent with the guidance in the *Act* that payroll representing workers is assessable.

7. CONSULTATION

Stakeholders are invited to provide feedback on the discussion paper, options, draft policy, and any additional comments that may be relevant to the issue.

Stakeholder comments will be accepted until **June 19, 2009**. When responding, please provide your name, organization, and address. Comments may be sent by mail, fax or e-mail to:

By e-mail: policy@worksafebc.com

By mail: Susan Hynes
Director
Policy and Research Division
WorkSafeBC
P.O. Box 5350, Stn. Terminal

Vancouver, B.C. V6B 5L5

By fax: 604 279-7599

WorkSafeBC's governing body, the Board of Directors, will consider the options expressed by stakeholders before it adopts any amendments to the current policies.

Please note that all comments become part of the Policy and Research Division's database and may be published, including the identity of organizations and those participating on behalf of organizations. The identity of those who have participated on their own behalf will be kept confidential according to the provisions of the *Freedom of Information and Protection of Privacy Act*.

APPENDIX A

PROPOSED DRAFT POLICY – ASSESSMENT MANUAL

Additions in Bold, Deletions Struckthrough



WORKING TO MAKE A DIFFERENCE

ASSESSMENT MANUAL

RE: Payroll – Categories

ITEM: AP1-38-2

BACKGROUND

1. EXPLANATORY NOTES

Assessments are based on payroll. Section 38 imposes an obligation on employers to report the amount of their payroll to the Board. This policy discusses the main categories of payroll.

2. THE ACT

See Item AP1-38-1.

Section 39(1), in part:

For the purpose of creating and maintaining an adequate accident fund, the Board must every year assess and levy on and collect from independent operators and employers in each class, by assessment rated on the payroll, or by assessment rated on a unit of production, or in a manner the Board considers proper, sufficient funds, according to an estimate to be made by the Board ...

POLICY

~~(a) — General~~1. GENERAL

Assessable payroll is considered by the Board under four general categories, any ~~one~~ of which may or may not be applicable to an ~~employer~~ **firm**. These are:

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- wages and salaries;
- principals' earnings;
- contractors' earnings; and
- Personal Optional Protection amount (covered in Item AP1-2-3).

~~(b)~~ ~~Wages and salaries~~^{2.} **WAGES AND SALARIES**

~~Wages and salaries include the gross earnings of all workers, except those covered under one of the other above categories. These earnings~~ **Assessable payroll** includes wages, salaries, commissions, holiday pay, bonuses, and piecework, as well as any other means or manner by which a worker is paid for services. ~~Earnings are covered~~ **This payroll may be assessed** even though the worker has not received an income tax statement, or has not had income tax, Canada Pension Plan contributions or Employment Insurance premiums deducted from the remuneration.

~~(c)~~ ~~Shareholders'~~^{3.} **PRINCIPALS' EARNINGS**

As noted in Item AP1-1-4, an active principal, shareholder, director, or officer of a corporation is generally considered to be a worker under the Act. The total ~~remuneration~~ **earnings** of paid to each active principal, shareholder, director, or officer of a corporation ~~is~~ **are** assessable. ~~Remuneration~~ **Earnings** is defined as **include** any payment made to ~~the~~ **a** principal, **shareholder, director or officer** regardless of the label attached to it, ~~It includes:~~ **such as:**

- earnings shown in official statements of remuneration issued by the corporation for income tax purposes;
- management fees;
- payments purporting to reimburse business expenses except for the payment of out-of-pocket expenses; and
- payments of personal expenses made on behalf of the active **principal, shareholder, director, or officer;** and
- **dividends.**

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If a director of a publicly traded company receives an official income tax statement from the company for directors' fees, these are not assessable if the director:

- only attends periodic meetings;
- is not a part-time or full-time employee; and
- is not an officer of the corporation.

Fees paid to directors of private companies are assessable.

~~Dividends are not considered part of payroll unless paid as remuneration for activity in the company.~~

Earnings in official income tax statements issued by the corporation to a spouse, child or family member of a principal, ~~or~~ shareholder, **director or officer** are included in payroll and are assessable.

If an individual is an active **principal**, shareholder, director, or officer of more than one registered firm, then the combined remuneration from those firms is assessable. The combined earnings are prorated between the various firms as is the excess earnings if the earnings are above the maximum **wage**.

~~(d)~~ **Contractors' earnings**⁴. **CONTRACTORS' EARNINGS**

The earnings of non-registered labour contractors must be included in the assessable payroll. For labour-only contracts, the ~~employer~~**firm** is assessed on the gross value of each contract.

For contracts involving the supply of labour and equipment, an equipment allowance may be deducted from the gross contract value where the contract requires use of revenue-producing equipment. The amount of the allowance will be determined having regard to such factors as the cost of purchasing the equipment and its ongoing operating cost and should be 15%, 40% or 75%.

Reimbursements for materials supplied by the contractor may be deducted from the gross contract amount where supported by receipts.

~~An employer~~ **firm** may be registered as being an independent firm in a situation where payments to the firm by a prime contractor were previously included in the prime

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contractor's payroll on the erroneous assumption that the employer**firm** was a labour contractor. The payments may be retroactively excluded from the prime contractor's payroll, but not beyond the effective date of the registration of the subcontracting firm.

PRACTICE

For any relevant PRACTICE information, readers should consult the Practice Directives available on the ~~WCB~~**WorkSafeBC** website.

~~With regard to part (c) of the POLICY in this Item, readers should see, in particular, Practice Directive "Shareholder Earnings – Assessment of Dividends" – AP1-38-2(A) – on the WCB website at http://www.worksafebc.com/law_and_policy/practice_directives/assessment_and_revenue_services~~

~~With regard to part (d) of the POLICY in this Item, a list of established equipment allowances will be available on the WCB website by January 1, 2003.~~

EFFECTIVE DATE:	April 1, 2005
AUTHORITY:	ss. 38(1) and 39(1), <i>Workers Compensation Act</i> .
CROSS REFERENCES:	See also Coverage under the <i>Act</i> – Distinguishing Between Employment Relationships and Relationships Between Independent Firms (AP1-1-3) with respect to principals of corporations, Coverage under <i>Act</i> – Workers (AP1-1-5), Coverage under <i>Act</i> – Labour Contractors (AP1-1-6), Personal Optional Protection (AP1-2-3), Extending the Application of the <i>Act</i> (AP1-3-1), Fishing (AP1-4-1), Payroll – Principles for Determining (AP1-38-3) and Maximum Wage Rate (AP1-38-6) in the <i>Assessment Manual</i> .
HISTORY:	A clarification to the payroll amendment limitations in part (d) was made effective April 1, 2005. A housekeeping change was made to the "Practice" section of this policy, effective December 31, 2003. Consequential changes to this Item made as a result of the <i>Workers Compensation Amendment Act (No. 2), 2002</i> were effective on March 3, 2003. This Item resulted from an editorial consolidation of the former <i>Assessment Policy Manual</i> , which was effective on January 1, 2003. The Policy in this Item continued the substantive requirements that existed before the consolidation, with any wording changes necessary to reflect legislative and other changes that had

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APPLICATION:

occurred. Policies No. 40:10:10, 40:10:30, 40:10:40 and 50:50:00 in the former *Assessment Policy Manual* were replaced, in part, by this Item. The amended policy applies to all decisions on or after ~~April 1, 2005~~.