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DISCUSSION PAPER #12

SALARY vs DIVIDENDS (2013 version)

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Salary vs Dividends (an old chestnut re-examined)

For many years, accountants and tax advisors have continued to question the best way to minimize income tax through the use of salaries versus dividends. The issue is that computations can prove that paying only dividends and not paying any salary results in current savings of income tax, and possibly long term increases in funds available for retirement.

However, not earning any salary means that the business owner will not be able to contribute to the Canada Pension Plan or to a Registered Retirement Savings Plan. The dividend only approach results in the owners' retirement funds being accumulated in an operating company (or a holding company when tax planning and creditor-proofing considerations are addressed) and then are available for future distribution.

Unfortunately, for business owners the salary vs dividend question does not lend itself to an easy explanation. Therefore, to make this understandable and we will review the matter in 3 parts:

The Conservative Approach
Some Arithmetic
Other Considerations

The Conservative Approach

Most of us in the tax advice business tell our clients who own and operate an active business corporation that has annual taxable income of less than $500,000, to do as follows:

1. Pay a salary to each owner/manager that will permit the maximum RRSP contribution for the following year (in 2013, a salary of $134,833 will result in the maximum 2014 RRSP deduction of $24,270);

2. Pay reasonable salaries to spouses and children if they work in the business (even minor children as long as they provide services to the company);

3. Pay dividends to the owner/manager, spouse and children if they are shareholders and there are funding requirements beyond the amounts that salaries will permit; and

4. The remaining profit of the business should be retained by the company to enjoy the benefits of the low rate of corporation tax.

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If the corporation has taxable income in excess of the $500,000 small business deduction limit, traditional approach is to pay a salary to maximize the business owners RRSP then pay a salary "bonus" of an amount required to bring the corporation's taxable income down to the $500,000 limit. This strategy ensured that the corporation would not pay "high rate" corporation tax. The problem is that corporate income tax rates have decreased over the last few years and therefore thinking has changed with respect to paying a bonus when the corporate taxable income exceeds the $500,000 small business limit.

Even though professional accountants continue to advise their clients to pay a salary to maximize RRSP contributions, it is becoming evident that having corporations pay the "high general rate" of corporate income tax since it has come down to 26.5% in Ontario when taxable income is greater than $500,000 rather than pay the salary bonus, especially if the funds are not needed currently. This strategy is compelling since it avoids paying tax at 46.41% (highest non "super tax" personal tax rate) resulting in an income tax deferral of 19.91% (46.41%- 26.5%). In the event that an individual is paying tax at the "super tax" rate, the deferral is 23.03%.

Some Arithmetic

Accountants may not be good at math, but we CAN do simple arithmetic. To illustrate the concepts discussed above, let's look at some numbers:

This model assumes that the shareholder/manager has less than $500,000 of taxable income and that all income is taxed at the "marginal" tax rate of 46.41% (Ontario 2013):

Taxable income in corporation	$125,000
Corporation income tax at 15.5%	*$ 19,375*
Funds available for dividend	$105,625
Dividend	$105,625
Personal tax on dividend	*$ 34,400*
Total corporation and personal tax	*$ 53,775*
Tax on salary of $125,000	$ 58,000
Difference (saving) of dividend vs salary	$ 4,230

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If the business owner's salary or dividend is his/her only source of income, the tax rates are lower and there is still an advantage to a dividend.

Taxable income in corporation	$125,000
Corporation income tax at 15.5%	*$ 19,375*
Funds available for dividend	$105,625
Dividend	$105,625
Personal tax on dividend	*$ 14,780*
Total corporation and personal tax	*$ 34,155*
Tax on salary of $125,000	$ 38,350
Difference (saving) of dividend vs salary	$ 4,195

The above examples do not account for other factors such as the company portion of CPP premiums and Ontario Health Tax premiums payable if the corporation's total payroll is in excess of $400,000.

Can a deferral be almost like a savings? Well, considering that the highest personal tax rate is 46.41% and the corporation tax rate on income of $500,000 or less is 15.5%, then the income tax deferred by leaving income in the corporation is 30.91%. These funds can be used to finance the company or invested until required by the owner/manager.

Other Matters to Consider

OK, so now we know that a dividend only plan will save current tax. But is that really the only consideration? If a business owner receives only dividends he/she will not be able to make contributions to either the CPP or an RRSP. The reason for this is that dividends are not defined as "earned income" for RRSP purposes or pensionable earnings for CPP purposes. That may be OK for some business owners, but many want to have the opportunity to receive CPP benefits when they retire (CPP just bought Neiman – Marcus so they should have the dough to pay out!) and they look at RRSP contributions as a "forced savings" program to prevent undisciplined spending.

Other issues include having a regular, recurring salary in order to establish credit and qualify for a housing mortgage. Although income from dividends might be substantial, lending institutions may treat it as "discretionary" and give it less credence than a salary from a corporation.

Child care expense claims may also be affected by dividend income in that it is not considered "earned" and thus the owner/manager may not be entitled to claim child care costs.

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Another matter is the "clawback" of the Old Age Security ("OAS") pension. The taxable amount of a dividend received from a private corporation is usually subject to a 25% "gross up" (a complicated reason not dealt with in this paper). As a result the dividend may result in reported income greater than the threshold and thus a repayment of all or part of the OAS received.

The final issue for discussion is the $750,000 lifetime capital gains exemption (note that this will increase to $800,000 for 2014 and be indexed annually after that). Without going into the finer details, use of a dividend strategy for owner compensation will result in funds building up in the corporation which are not required to support the active business operations. (example – portfolio investments). If this occurs, the business may not qualify for the exemption without some planning through the use of a "holding company" or family trust.

The Final Word

The salary versus dividend decision is complicated and the best method for each business owner needs to be addressed individually. There is no "one size fits all" approach.

We encourage you to contact us to review your personal situation and have us develop a plan that is consistent with your objectives for your financial future.

Please contact one of our Partners with your questions.

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