Salary or Dividends – Compensation Strategy for Incorporated Business Owners

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Are you an incorporated business owner wondering whether you should pay yourself a salary or dividends? It is not a simple straightforward question and there is no one-size-fits-all answer to it. Due to the introduction of eligible and non-eligible dividends and the changes of the gross-up and dividend tax credits in the past few years, the simple rules of thumb that used to work in the past do not apply anymore. You should consider the following five factors based on your own specific circumstances to craft your own salary-dividend strategy.

Annual Spending

First, approximately how much money do you need to take out from your company for the whole year for personal spending? You should plan your salary-dividend strategy for the whole year rather than on a piecemeal basis. Why? As an individual, your personal tax is determined based on progressive tax rates that apply to your total income for the whole year.

Income Splitting

Second, do you have a spouse or adult children in the lower tax bracket who can receive salaries or dividends from your company? Splitting income reduces the overall tax bill for your family. However, it would be prudent for you to check with a tax accountant before making any payments to family members. There are many tax traps in this income splitting area. For example, salaries paid to family members needs to be reasonable. Generally speaking, salaries would not be considered as reasonable if you are not willing to pay the same salaries to another person not related to you for performing the same duties. Also, dividends paid to minor children are subject to kiddie tax at the top marginal rates.

Combined Personal And Corporate Taxes

Third, compare the total income tax that you and your company will have to pay on the money taken out as salaries vs. dividends. Salaries are expenses to your company. Dividends are not. What does this mean? If the money is taken out as salaries, your company does not have to pay tax. All tax is borne by you. On the other hand, if the money is taken out as dividends, your company has to pay tax on the income, and then distributes the after-tax income to you as dividends. Unlike salaries, dividends are taxed on your hands based on a special gross-up and dividend tax credit system. This special tax system is intended to integrate your personal tax on dividends with your company's corporate tax on income such that the total tax to be paid by you and your company would be the same as the personal tax you would have to pay if the money is taken out as salary. However, due to the differences in provincial tax, we do not have a perfect tax integration system in Canada. Depending on the province you live in and your income level and that of your company, you may find either a tax saving or a tax cost for taking money out as dividends. For 2014, the discrepancy in the total tax for taking money out as dividends instead of salaries could range from 2.4% of tax saving to 8.1% of tax cost.

Employment or Earned Income Versus Investment Income

Fourth, salaries and dividends are two different types of income for tax purposes. Salaries are employment income or earned income. Dividends are investment income.

What does this mean?

Let's talk about salaries as employment income or earned income.

- For 2014, salaries of $3,500 up to $52,500 are subject to CPP/QPP premiums. The combined premium rate for you and your company is 9.9% for CPP or 10.35% for QPP. This can be either a positive or negative factor for taking salaries depending whether you are interested in participating in the CPP/QPP. Note that other than pension benefits, the CPP and QPP also provide disability benefits.
- Additionally, salaries will allow you to contribute to an RRSP or an individual pension plan as your retirement vehicles.
- Salaries also qualify you for child care deductions and employment tax credit. Some form of salaries also helps to justify non-taxable benefits such as health and dental insurance coverage.
- However, salaries are subject to normal payroll deductions. Your company needs to determine the right amount of source deductions and to remit these to the CRA in a timely manner. The penalty for late remittance can be as high as 20% for repeated late payments.
- Also, salaries paid to family members are likely to be scrutinized by the CRA for reasonability.

Now, let's talk about dividends as investment income.

- Unlike salaries, dividends are not subject to the same reasonability test. Dividends can be an effective means of income splitting with family members who may own shares in your company directly or indirectly through a family trust. However, as I said before, dividends should not be paid to children under the age of 18 to avoid the punitive "kiddie tax."
- Shareholders with no income other than dividends can receive a certain amount of dividends without paying any personal tax. The amounts of tax-free dividends vary by provinces and the types of dividends. For example, an Ontario shareholder may receive up to approximately $43,000 of non-eligible dividends or $49,000 of eligible dividends without paying any personal taxes.
- Dividends are not subject to withholding tax at source. However, you may be subject to quarterly income tax installments if you continually take dividends.
- Dividends are not subject to CPP/QPP contribution premiums.
- However, dividends do not generate contribution rooms for RRSP or individual pension plan.
- Also, dividends do not qualify you for child care deductions or employment tax credit.

Tax Deferral Benefits

Fifth, if you do not need to take all the income out of your company for personal spending, there is a "tax deferral benefit" of leaving the income in the company. This is because your company's corporate tax rate generally would be lower than your personal tax rate. For 2014, for business owners in the top marginal tax bracket, the tax deferral benefits vary by provinces and range from 13% to 36% depending on the income level of your company.

In conclusion, you should consider the above five factors to design your own compensation strategy (salary or dividend) based on your specific circumstances.

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