Salary vs. dividends for business owners

One of the most recurring questions business owners ask is - should they take salary or dividend income from their business?

Some accountants suggest a bonus-down approach. This means reducing the business income to the amount that is subject to the low corporate business income tax rate (i.e., the so-called small business limit) by paying a salary or bonus. Then any additional money can be withdrawn as dividends. Better yet, unless required, the after-tax earnings can be left in the company for use by the business and to continue the tax deferral.

Others may argue that the tax rate on non-eligible dividends is less than the tax rate on salary income, so there's an opportunity for absolute tax savings by receiving only dividends.

Many accountants suggest business owners receive enough salary to maximize Canada Pension Plan contributions, and if possible to create the maximum RRSP contribution room.

There is no right or wrong answer. It depends on factors such as the business owner's personal and business circumstances, preferences, retirement planning and financial discipline.

Advantage of taking only dividends

Generally, the personal tax rate on dividend income is lower than the tax rate on salary income. Also dividend income is not subject to federal and provincial/territorial payroll taxes such as Canada Pension Plan (CPP)/Quebec Pension Plan QPP), employment insurance, employer health tax, workers' compensation/safety insurance premium etc. This means more after tax money is left in the owner-manager's hands if dividends are received, than if the same amount was received as salary.

This can also mean that less money needs to be paid from the company as dividends, and this approach offers a tax deferral advantage since more money may be left inside the company for other business purposes.

If the business owners decide to start collecting CPP/QPP benefit early (from age 60) while still working in their business, withdrawing money from the corporation as dividend may be attractive. While CPP/QPP benefit will increase cash inflow, the dividend income (unlike salary) does not require CPP/QPP contribution, and thus, saving both business owner's and corporation's CPP/QPP contribution.

Disadvantage of taking only dividends

One of the most apparent disadvantages, of taking only dividends from the company, is there is no contribution to CPP/QPP. With no contribution to CPP/QPP, there is no CPP/QPP benefit for business owners. Many individuals value CPP/QPP benefits and may prefer to contribute to the CPP/QPP. For them the CPP/QPP contribution is not an expense, but an investment for their retirement.

Another apparent disadvantage is dividend income does not create RRSP contribution room. Unless business owners have other sources of earned income that create RRSP contribution room, they will not be able to contribute to RRSPs. This may have a direct impact on their retirement income planning.

They can invest the income tax and payroll tax savings resulting from taking dividends vs. salary, in non-registered accounts or a tax-free savings account (TFSA). However, both options have limitations. Investments in non-registered accounts do not provide tax-deferred growth like RRSPs, and the contribution limit to a TFSA may restrict their retirement income pool.

Another disadvantage of investing in a non-registered portfolio or TFSA is the possible impact from a lack of financial discipline. Many of us have a long wish list – the things we would like to buy, places we would like to visit - if we just had little more money available. People are more likely to spend the extra money they have or withdraw it from a non-registered account or TFSA, than from an RRSP. The end result is the greater possibility of a shortfall in retirement income, if savings and investments are not in an RRSP.

For younger families with childcare expenses, another disadvantage is they cannot deduct childcare expenses from their dividend income. This tax deduction is available if the individual has income from employment or a business.

For seniors, the dividend gross-up may trigger claw-back of Old Age Security payments.

If the excess after-tax corporate income, not withdrawn as dividends, is left inside the company, it may be exposed to the claims of the creditors of the corporation. To avoid this, the business owner may need to establish a holding company or family trust, to remove the excess cash from the operating company. Both options have their own cost and benefits. From the dividend vs. salary discussion perspective, note that either additional planning is required or the excess funds left in the company could be subject to creditors' claims.

The numbers

A discussion like this is incomplete without looking at some numbers. Let's assume in 2014 a corporation eligible for small business deduction has pre-tax income of $100,000 and needs to pay remuneration to the business owner. The business owner is wondering if he should have the company pay the tax on $100,000 of income and withdraw the remaining amount as a dividend, or withdraw the entire amount as salary (i.e., leaving no taxable income in the corporation, and therefore no corporate income tax). To make the comparison more meaningful, let's further assume the business owner has unused RRSP contribution room of $17,576.[1] The business owner maximizes RRSP contributions each year, and

[1] ($100,000 less corporate portion of 2013 CPP contribution) X 18%.

the tax rate when money is withdrawn from the RRSP is 25 per cent.

As shown in the table attached, the cash available to the business owner on an annual basis is greater if the money is received from the corporation as dividends compared to salary. However, this conclusion does not consider the following:

1. The RRSP contribution, and tax-deferred growth inside an RRSP
2. The CPP/QPP contribution and potential CPP/QPP benefit payments until death

While the potential CPP/QPP benefits and growth of the RRSP may be difficult to predict, the table also includes the after-tax RRSP withdrawal in the future of the original investment.

Once this is factored in, both alternatives provide a comparable result. The salary option can also provide tax-deferred RRSP growth and CPP/QPP benefits until death.

Conclusion

There is no one-size-fits-all solution when discussing whether a business owner should receive dividends or salary. In some cases, dividends will be preferable, while in other cases salary. In some cases a mix of both dividend and salary income may provide better results. Hence, before assuming that dividends are the best option, it's important to consider the business owner's individual circumstances and retirement planning objectives.

Particulars	AB		BC		MB	
Corporate tax calculation	**Dividend**	**Salary**	**Dividend**	**Salary**	**Dividend**	**Salary**
Corporate income before salary	100,000	100,000	100,000	100,000	100,000	100,000
Salary	-	(97,575)	-	(97,575)	-	(97,575)
CPP/QPP employer contribution	-	(2,425)	-	(2,425)	-	(2,425)
Taxable income	100,000	-	100,000	-	100,000	-
Corporate tax rate	14.00%	14.00%	13.50%	13.50%	11.00%	11.00%
Corporate tax rate	14,000	-	13,500	-	11,000	-
Dividend from corporation	**86,000**	**-**	**86,500**	**-**	**89,000**	**-**
Personal tax calculation (Only basic exemption, CPP/QPP and employment amount considered)						
Gross-up dividend income	101,480	-	102,070	-	105,020	-
Salary income	-	97,575	-	97,575	-	97,575
RRSP deduction	-	(17,576)	-	(17,576)	-	(17,576)
Taxable income	101,480	79,999	102,070	79,999	105,020	79,999
Income tax (2014 tax rates)*	(12,165)	(18,299)	(11,786)	(16,999)	(20,167)	(21,271)
Personal CPP/QPP contribution	-	(2,425)	-	(2,425)	-	(2,425)
	89,315	59,275	90,284	60,575	84,853	56,303
Dividend gross-up	(15,480)	-	(15,570)	-	(16,020)	-
Cash to business owner	**73,835**	**59,275**	**74,714**	**60,575**	**68,833**	**56,303**
RRSP contribution	-	17,576	-	17,576	-	17,576
Tax on RRSP withdrawal in future at 25%		(4,394)		(4,394)		(4,394)
Cash + RRSP investment	**73,835**	**72,457**	**74,714**	**73,757**	**68,833**	**69,485**
Next year's RRSP contribution room		17,563		17,563		17,563

* Tax calculated using online calculator available at taxtips.ca

Particulars	NB		NL		NT	
Corporate tax calculation	**Dividend**	**Salary**	**Dividend**	**Salary**	**Dividend**	**Salary**
Corporate income before salary	100,000	100,000	100,000	100,000	100,000	100,000
Salary	-	(97,575)	-	(97,575)	-	(97,575)
CPP/QPP employer contribution	-	(2,425)	-	(2,425)	-	(2,425)
Taxable income	100,000	-	100,000	-	100,000	-
Corporate tax rate	15.50%	15.50%	15.00%	15.00%	15.00%	15.00%
Corporate tax rate	15,500	-	15,000	-	15,000	-
Dividend from corporation	**84,500**	**-**	**85,000**	**-**	**85,000**	**-**
Personal tax calculation (Only basic exemption, CPP/QPP and employment amount considered)						
Gross-up dividend income	99,710	-	100,300	-	100,300	-
Salary income	-	97,575	-	97,575	-	97,575
RRSP deduction	-	(17,576)	-	(17,576)	-	(17,576)
Taxable income	99,710	79,999	100,300	79,999	100,300	79,999
Income tax (2014 tax rates)*	(13,590)	(21,028)	(12,236)	(19,920)	(7,293)	(16,247)
Personal CPP/QPP contribution	-	(2,425)	-	(2,425)	-	(2,425)
	86,120	56,546	88,064	57,654	93,007	61,327
Dividend gross-up	(15,210)	-	(15,300)	-	(15,300)	-
Cash to business owner	**70,910**	**56,546**	**72,764**	**57,654**	**77,707**	**61,327**
RRSP contribution	-	17,576	-	17,576	-	17,576
Tax on RRSP withdrawal in future at 25%		(4,394)		(4,394)		(4,394)
Cash + RRSP investment	**70,910**	**69,728**	**72,764**	**70,836**	**77,707**	**74,509**
Next year's RRSP contribution room		17,563		17,563		17,563

* Tax calculated using online calculator available at taxtips.ca

Particulars	NS		NU		ON	
Corporate tax calculation	**Dividend**	**Salary**	**Dividend**	**Salary**	**Dividend**	**Salary**
Corporate income before salary	100,000	100,000	100,000	100,000	100,000	100,000
Salary	-	(97,575)	-	(97,575)	-	(97,575)
CPP/QPP employer contribution	-	(2,425)	-	(2,425)	-	(2,425)
Taxable income	100,000	-	100,000	-	100,000	-
Corporate tax rate	14.00%	14.00%	15.00%	15.00%	15.50%	15.50%
Corporate tax rate	14,000	-	15,000	-	15,500	-
Dividend from corporation	**86,000**	**-**	**85,000**	**-**	**84,500**	**-**
Personal tax calculation (Only basic exemption, CPP/QPP and employment amount considered)						
Gross-up dividend income	101,480	-	100,300	-	99,710	-
Salary income	-	97,575	-	97,575	-	97,575
RRSP deduction	-	(17,576)	-	(17,576)	-	(17,576)
Taxable income	101,480	79,999	100,300	79,999	99,710	79,999
Income tax (2014 tax rates)*	(14,382)	(21,857)	(8,095)	(14,862)	(11,592)	(18,281)
Personal CPP/QPP contribution	-	(2,425)	-	(2,425)	-	(2,425)
	87,098	55,717	92,205	62,712	88,118	59,293
Dividend gross-up	(15,480)	-	(15,300)	-	(15,210)	-
Cash to business owner	**71,618**	**55,717**	**76,905**	**62,712**	**72,908**	**59,293**
RRSP contribution	-	17,576	-	17,576	-	17,576
Tax on RRSP withdrawal in future at 25%		(4,394)		(4,394)		(4,394)
Cash + RRSP investment	**71,618**	**68,899**	**76,905**	**75,894**	**72,908**	**72,475**
Next year's RRSP contribution room		17,563		17,563		17,563

* Tax calculated using online calculator available at taxtips.ca

Particulars	PE		QC		SK	
Corporate tax calculation	**Dividend**	**Salary**	**Dividend**	**Salary**	**Dividend**	**Salary**
Corporate income before salary	100,000	100,000	100,000	100,000	100,000	100,000
Salary	-	(97,575)	-	(97,078)	-	(97,575)
CPP/QPP employer contribution	-	(2,425)	-	(2,922)	-	(2,425)
Taxable income	100,000	-	100,000	-	100,000	-
Corporate tax rate	15.50%	15.50%	19.00%	19.00%	13.00%	13.00%
Corporate tax rate	15,500	-	19,000	-	13,000	-
Dividend from corporation	**84,500**	**-**	**81,000**	**-**	**87,000**	**-**
Personal tax calculation (Only basic exemption, CPP/QPP and employment amount considered)						
Gross-up dividend income	99,710	-	95,580	-	102,660	-
Salary income	-	97,575	-	97,078	-	97,575
RRSP deduction	-	(17,576)	-	(17,576)	-	(17,576)
Taxable income	99,710	79,999	95,580	79,502	102,660	79,999
Income tax (2014 tax rates)*	(16,247)	(21,552)	(15,297)	(22,701)	(14,416)	(19,895)
Personal CPP/QPP contribution	-	(2,425)	-	(2,922)	-	(2,425)
	83,463	56,022	80,283	53,879	88,244	57,679
Dividend gross-up	(15,210)	-	(14,580)	-	(15,660)	-
Cash to business owner	**68,253**	**56,022**	**65,703**	**53,879**	**72,584**	**57,679**
RRSP contribution	-	17,576	-	17,576	-	17,576
Tax on RRSP withdrawal in future at 25%		(4,394)		(4,394)		(4,394)
Cash + RRSP investment	**68,253**	**69,204**	**65,703**	**67,061**	**72,584**	**70,861**
Next year's RRSP contribution room		17,563		17,474		17,563

* Tax calculated using online calculator available at taxtips.ca

Tax and planning

Living benefits

THE Great-West Life ASSURANCE COMPANY

Particulars	YT	
Corporate tax calculation	**Dividend**	**Salary**
Corporate income before salary	100,000	100,000
Salary	-	(97,575)
CPP/QPP employer contribution	-	(2,425)
Taxable income	100,000	-
Corporate tax rate	15.00%	15.00%
Corporate tax rate	15,000	-
Dividend from corporation	**85,000**	**-**
Personal tax calculation (Only basic exemption, CPP/QPP and employment amount considered)		
Gross-up dividend income	100,300	-
Salary income	-	97,575
RRSP deduction	-	(17,576)
Taxable income	100,300	79,999
Income tax (2014 tax rates)*	(10,705)	(17,869)
Personal CPP/QPP contribution	-	(2,425)
	89,595	59,705
Dividend gross-up	(15,300)	-
Cash to business owner	**74,295**	**59,705**
RRSP contribution	-	17,576
Tax on RRSP withdrawal in future at 25%		(4,394)
Cash + RRSP investment	**74,295**	**72,887**
Next year's RRSP contribution room		17,563

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