The Navigator

Wealth Management

RBC Wealth Management Services

Salary versus dividend income

The remuneration process for the owner-manager

The type of remuneration, whether it be salary or dividends, that an owner-manager decides to draw from their business will have an impact on both the owner-manager and their corporation. This article discusses the tax implications of receiving a salary versus dividends as well as some non-tax considerations that are of importance when deciding which form of remuneration you, as an owner-manager, should take.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Please contact us for more information about the topics discussed in this article.

Types of remuneration

As an employee and shareholder of a Canadian-Controlled Private Corporation (CCPC), you have the flexibility of receiving your remuneration in the form of a salary, dividend, or a combination of both. The most tax-efficient type of remuneration for you and your corporation will be a determining factor in which one you choose. The tax treatment of salary and dividend income is different at both the corporate and individual level. The following discusses some of the tax implications and other considerations that you should keep in mind when deciding on the type of remuneration to receive.

Salary remuneration

At the corporate level

- Salary paid by your corporation is considered a tax deductible expense and will lower the corporation's taxable income.
- In order for a salary payment to be deductible by the corporation, the amount paid must be reasonable. For owner-managers, reasonableness is generally not an issue provided you are actively engaged in the operations of the corporation and contribute to the profits earned by the corporation using your special know-how or entrepreneurial skills.

A dividend payment is not subject to the reasonableness test. Instead, corporate solvency tests may need to be used and restrictions on the capital stock itself should be identified when determining whether a dividend can be paid and the amount of the dividend that can be paid.

- The corporation will incur an additional expense in the form of payroll taxes when a salary payment is made. The corporation has to match an employee's contribution to the Canada Pension Plan (CPP)/ Quebec Pension Plan (QPP). The corporation may not have to match an employee's contribution to the Canada's Employment Insurance (EI) program where the employee is also a shareholder. This is because EI premiums are not required for an employee who is also a shareholder controlling more than 40% of the voting stock of the corporation. Voluntary participation is permitted.

- Salary paid by the corporation may attract other payroll expenses such as provincial workers' compensation and health tax payable by the corporation (depending on the province in which the corporation is located and the thresholds in that province).

- Salary paid by the corporation will be subject to tax and payroll withholdings at the source (e.g., income taxes and employee's portion of CPP/QPP).

At the individual level

- The gross amount of salary income (before source deductions) is employment income and is subject to tax at your marginal tax rate in the year it is received.

- You may be eligible for non-refundable tax credits in addition to the basic personal amount. Some of the federal non-refundable tax credits include a credit for CPP/ QPP contributions made by you, personally as the employee, and the Canada employment amount.

Dividend remuneration

At the corporate level

- A dividend payment is not a deductible expense for the corporation.

- Since dividends are paid out of the corporation's after-tax retained earnings, they have already been subject to a level of tax within the corporation.

- A dividend payment is not subject to the reasonableness test. Instead, corporate solvency tests may need to be used and restrictions on the capital stock itself should be identified when determining whether a dividend can be paid and the amount of the dividend that can be paid.

- Canadian corporations may pay both "eligible" and "non-eligible" dividends. Eligible dividends generally include dividends paid by Canadian corporations or CCPCs that are subject to the general corporate tax rate. Income of a CCPC that was subject to the small business corporate tax rate will generally be paid out as non-eligible dividends, which are taxed at a higher rate than eligible dividends at the individual level. The dividend may also be designated as a capital dividend if the corporation has a positive balance in its capital dividend account. Capital dividends are generally available where the corporation earns capital gains. Capital dividends may be paid to a Canadian resident shareholder tax-free.

At the individual level

- An individual may be required to pay quarterly tax instalments if their income taxes payable (after deducting taxes withheld at source)

Salary income is considered pensionable earnings for CPP/QPP purposes while dividend income is not. Therefore, if you receive salary income, you may be entitled to CPP/QPP benefits.

is more than $3,000 ($1,800 for Québec) for the current year and either of the two preceding years. If you receive primarily dividends or only dividend income, you need to be mindful of a possible quarterly tax instalments requirement since your dividend income will not be subject to withholding tax at source.

- A dividend payment is grossed-up by an additional 17% (if non-eligible) or 38% (if eligible) to arrive at the taxable amount that is included in an individual's income. For example, if you receive an actual dividend of $1,000, you will need to include $1,170 or $1,380 of income on your tax return depending on the type of dividend you receive. Due to this gross-up, the amount of the taxable dividends may have a bigger impact on your eligibility for certain income-tested benefits, such as the Old Age Security.

- In addition to the basic personal amount, you will be eligible for a non-refundable dividend tax credit which is meant to reflect the corporate taxes already paid on this income prior to distribution.

Other considerations

- RRSP contribution room is calculated based on "earned income", which includes salary but not dividend income. If your only source of income is dividend income, you will not be able to build RRSP contribution room.

- The maximum RRSP contribution room is limited to the lesser of 18% of your "earned income" and a maximum threshold. Paying a salary beyond this level does not yield any additional RRSP contribution room. If you live in a province where there is a tax advantage to paying dividends (versus salary), consider still paying sufficient salary to maximize your RRSP contributions. Then pay dividends to supplement your income needs.

- Contributions to an RRSP are deductible against any type of taxable income including dividend income. If you have other funds available to make an RRSP contribution and have used RRSP contribution room, you may be able to benefit from the tax deduction in the current year resulting in greater after-tax cash flow to you.

- Salary income is considered pensionable earnings for CPP/QPP purposes while dividend income is not. Therefore, if you receive salary income, you may be entitled to CPP/QPP benefits (which may include a retirement pension and survivor, death and disability benefits available to CPP/QPP contributors and their family members).

- An owner-manager who receives pension-eligible income may be a candidate for an Individual Pension Plan (IPP), which is a defined benefit pension plan established by a corporation for an individual. Pension-eligible income includes salary income but does not include dividend income.

- The ability to contribute to an RRSP/IPP allows you to grow your investments on a tax-deferred basis.

Conclusion

The form of compensation you receive from your corporation should depend on your facts and circumstances as well as your corporation's financial position. Both tax and non-tax factors should be considered when selecting the type of remuneration you wish to receive. You should discuss this matter with a qualified tax advisor to help determine which option is best for you.

Please contact us for more information about the topics discussed in this article.