Wealth Management

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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Salary versus dividend income

Remuneration for an owner-manager

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

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 combination of both. When choosing from these options, the most tax-efficient type of remuneration for you and your corporation will be a determining factor. The tax treatment of salary and dividend income is different at both the corporate and individual level.

Here are 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 may be tax-deductible, as such it may lower your 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 as long as you're actively engaged in the operations of the corporation and contribute to the profits earned by the corporation using your particular know-how or entrepreneurial skills.
- 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 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 or territory in which the corporation is located and the thresholds in that province or territory).

- 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's 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've 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 in situations where the corporation earns capital gains.

A dividend payment is grossed-up by an additional 15% (if non-eligible) or 38% (if eligible) to arrive at the taxable amount that's included in an individual's income.

Capital dividends may be paid to a Canadian resident shareholder tax-free.

At the individual level

- You may be required to pay quarterly tax instalments if your income taxes payable (after deducting taxes withheld at source) is more than $3,000 ($1,800 for Quebec) 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 won't be subject to withholding tax at source.

- A dividend payment is grossed-up by an additional 15% (if non-eligible) or 38% (if eligible) to arrive at the taxable amount that's included in an individual's income. For example, if you receive an actual dividend of $1,000, you'll need to include $1,150 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 Old Age Security.

- In addition to the individual tax credits such as 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.

- AMT may impact your tax liability for the tax year if you earn Canadian dividends. AMT aims to ensure that every Canadian individual pays a minimum amount of tax. The calculation of AMT is based on an "adjusted taxable income" which seeks to remove the advantages of certain tax-preferential items such as dividends that are eligible for the dividend tax credit. If the AMT calculated is greater than your regular tax liability, the AMT becomes your tax liability for the year. The difference between the AMT that you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability when your taxes payable exceed your AMT. For more information about AMT, ask an RBC advisor for an article on this topic.

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 won't be able to build RRSP contribution room.

- The maximum RRSP contribution room is limited to 18% of your "earned income" or a maximum threshold, whichever is lesser. Paying a salary beyond this level does not yield any additional RRSP contribution room. If you live in a province or territory where there's 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 unused 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 doesn't include dividend income.

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 won't be able to build RRSP contribution room.

- 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 particular situation and circumstances, as well as your corporation's financial position. In determining which option or what combination of salary and dividends is best for you, keep in mind that both tax and non-tax factors should be considered when selecting the type of remuneration you'd like to receive.

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