Payments from Your Company: Will They Be Salary Or Dividends?

Written by: Gordon Gallagher, CPA, CGA

You've incorporated your business/practice. Now you have a decision to make. How are you going to treat payments from the Company to yourself and any family members?

Remember: Cash in the Company belongs to the Company. Your choices are to treat withdrawals of Company cash as salary, dividends or a combination of salary and dividends.

Let's look at these choices to determine which would be best for you and the Company.

If you withdraw funds as salary

When you record your withdrawals from the Company as salary, the Company records an expense and reduces its taxable income – and accordingly, its tax liability. You will incur income tax on the salary received at your personal marginal income tax rates.

A salary is a payment for services rendered. Therefore, salary paid to your family members as a means of income-splitting needs to be determined/limited based on both reasonableness and the services performed.

Canada Pension Plan (CPP)

When you are paid a salary, there is an additional cost you must consider: Canada Pension Plan (CPP). The maximum CPP contributions for 2015 total $4,959.90 (employee and employer). Some individuals consider CPP to be an important part of their retirement plan. They are content to make annual contributions in order to receive government pension income on retirement. If receiving CPP pension income is important to you, then you should consider paying a minimum salary of $54,000 to maximize CPP contributions.

However, if you feel that saving and investing the $5,000 per annum would result in a greater return than receiving future CPP pension, then you may find dividends more preferable than salary income.

Employment Insurance (EI)

You are not required to pay EI premiums if you control more than 40 percent of the Company's shares, or if the employee and employer are not dealing at arm's length. This would include you as majority shareholder but could also include a spouse or common-law partner, children, parents and siblings.

However, Canada Revenue Agency will consider a related personal employment as insurable if it is reasonable to conclude that your employer would have hired a non-related person under a similar contract of employment.

Registered Retirement Savings Plan (RRSP)

A salary creates RRSP contribution room while dividends do not. The maximum RRSP contributions for the current taxation year are equal to the lower of 18 percent of earned income (including salary) of the prior year and a predetermined annual maximum. The annual maximum for 2015 is $24,930 ($138,500 of earned income).

The British Columbia Medical Association/Doctors of BC administers the Contributory Professional Retirement Savings Plan (CPRSP) for this province’s physicians. The plan assists physicians with saving for retirement by providing additional contributions to a doctor’s personal or spousal RRSP. In order to qualify for this plan the physician needs to create RRSP contribution room by receiving salary income.

If an RRSP is important to you and you wish to benefit from the CPRSP benefit, then you should consider receiving a salary.

Government filing/remittances

Payment of a salary requires calculating employee withholdings and remittances to CRA on a monthly basis or annually (if paid by an annual bonus).

Non-taxable employee benefits

Salary assists in providing non-taxable employee benefits such as extended health and dental coverage.

Personal borrowing

If you need to qualify for a personal mortgage, the financial institution may request your monthly or annual salary income.

If you withdraw funds as dividends

Dividends are paid out of the Company’s after-tax-retained earnings.

Dividends are an effective method of income-splitting with family members who own shares in the Company or own shares indirectly as beneficiaries of a family trust. Unlike salary, dividends are paid based on share ownership – not on services performed for the Company. The timing of dividend payments is in most cases at the discretion of the director(s) of the Company. Therefore, they can be paid based on the recipient’s personal income tax situation in that year.

The personal income tax rates on dividends are lower than regular/salary income as the lower rates take into account the income taxes already paid by the Company.

Income-splitting with low- or lower-income family members will result in your family being in an overall lower-income tax bracket. It will significantly reduce your family's overall tax liability. A certain level of dividends can be paid to low-income or no-income family members without incurring any personal income tax. A common example of a low-income family member is a spouse/child who is attending university and has minimal personal income

Warning: Avoid the so-called "kiddie tax"! Don't pay dividends to children who have not turned 18 in the year. In 2000 the federal government introduced the kiddie tax to prevent high-income individuals from reducing their income taxes by income-splitting with their minor children. Under kiddie tax rules, the receipt of dividend income from a private company by a child under age 18 will result in income tax at the highest federal tax rate. The child cannot use any other personal credits, except for the dividend tax credit, to reduce the personal income tax on these dividends.

If your Company has retained its after-tax profits, and is earning investment income on the undistributed funds, it will pay a tax recoverable upon the payment of taxable dividends to its shareholders. If the dividend is paid to a shareholder with little or no income, the refundable tax recovered by the Company will be more than the personal income taxes paid by the shareholder.

Note that an individual receiving dividend income may be required to pay quarterly personal income tax instalments.

Examples of Possible Salary/Dividend Strategy

- Dividends to low-income/inactive family members.
- Dividends to owner/managers who wish to avoid paying CPP premiums and are not concerned with making RRSP contributions.
- Salary to owners to maximize RRSP contributions and BCMA RRSP matching contributions. Any excess to be paid as dividends to the professional, inactive spouse or other lower-income family members.

Income tax facts – British Columbia (2015):

- Professional income or salary earned personally in excess of $150,000 is taxed at 45.80 percent.
- The first $500,000 of active business income earned in a corporation is taxed at 13.50 percent.
- Active business income earned in a corporation in excess of $500,000 is taxed at 26 percent.
- Non-active investment income earned in a corporation is taxed at 45.667 percent with 26.667 percent refundable upon the payment of taxable dividends by the corporation of three times the amount of refundable tax.

- Eligible dividends received by individuals with no other sources of income without incurring personal income tax: $49,284.
- Non-eligible dividends received by individuals with no other sources of income without incurring personal income tax: $22,285.

Note: Always ensure you seek independent accounting, tax, legal and investment advice that considers your particular situation and circumstances.

Gordon Gallagher *is a Senior Manager at Manning Elliott LLP. Contact Gordon at* ***604-557-5772*** *or* ***gordgal@manningelliott.com****.*