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The Compensation Conundrum: Will it be salary or dividends?

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When year-end approaches, owner-managers begin to ponder the age-old question: how should I pay myself this year? In other words, should I withdraw business profits from my corporation as salary (bonus) or as dividends?

In recent years, there have been numerous changes to the tax laws that impact the compensation decision, such as increases in the highest personal marginal tax rates in several provinces and modifications to taxation of dividends. Given these changes, what is the best remuneration strategy for a small business in 2017 and beyond?

Integration and the compensation decision

Owner-managers who run their businesses through corporations can choose to receive compensation from their corporations as either salary or dividends. If salary compensation is chosen, the owner-manager pays personal tax on the salary income. Alternatively, if dividend compensation is chosen, the company pays corporate tax when income is earned and the owner-manager pays personal tax when proceeds are distributed as a dividend. If there is "perfect integration", the amount of after-tax cash in the owner-manager's hands is the same whether all the corporate income is paid out as a salary or taxed in the corporation and then paid out as a dividend.

Absent perfect integration, however, a tax savings benefit can be derived when there is a "tax rate advantage" (tax savings) from paying dividends, whereby the total corporate and personal tax paid on dividend compensation is less than the personal tax paid on salary compensation. Conversely, a "tax rate disadvantage" occurs when there is a tax cost associated with the payment of dividends.

Regardless of whether or not perfect integration exists, there may still be a benefit from deferring payment of dividends to a future year since corporate tax on business income is payable in the current year but personal tax on the dividend is paid in a future year. Consequently, there will be a "tax deferral advantage" from paying deferred dividends if the current corporate tax payable on corporate income is less than the personal tax payable on salary. The difference between the corporate tax and the personal tax (the deferred amount) can be reinvested within the corporation to earn additional income until the dividend is ultimately paid, possibly many years later.

If corporate income will be distributed in the year it is earned, such as when the owner-manager needs funds for personal expenses, then the tax rate advantage is a key factor when choosing to compensate by dividends or salary. If corporate income does not necessarily need to be distributed in the current year, consideration should be given to paying deferred dividends. The tax deferral advantage, as well as any changes in the tax rate advantage between the current year and year of dividend payment, help to determine whether to pay deferred dividends or pay compensation in the current year.

Our previous reports, Rethinking RRSPs for Business Owners[1] and Bye Bye Bonus[2], provide a more detailed explanation of the tax rate advantage and tax deferral advantage.

The evolution of integration

The integration system was originally based on a combined federal/provincial corporate tax rate of 20% but, in reality, corporate tax rates have seldom equalled this theoretical 20% rate.[3]

For SBD Income, which is active business income up to the small business deduction limit ($500,000 federally and in most provinces),[4] corporate tax rates have decreased over time. The 2017 combined federal/provincial corporate tax rates on SBD Income range from 10.5% to 18.5% (illustrated in Figure 1), which is lower than the theoretical rate of 20%. To better align with the actual corporate tax rates, since 2016 the federal integration system for non-eligible dividends has been based on a theoretical corporate tax rate of 14.5%.

For active business income exceeding the small business deduction limit (ABI), the 2017 combined federal/provincial corporate tax rates range from 26% to 31% (illustrated in Figure 1). The system of eligible dividends was introduced to take these higher corporate tax rates into account and, since 2012, has been based on a theoretical corporate tax rate of 27.5%. Dividends distributed from ABI are eligible for an enhanced personal dividend tax credit to compensate for the higher corporate tax rate.

Although using theoretical corporate tax rates of 14.5% for SBD Income and 27.5% for ABI helps to align the integration systems better than the original 20% rate, we can see from Figure 1 that the actual corporate tax rates in each of the provinces (shown by the bars) still differ from the theoretical corporate tax rates (shown by the dashed lines). This has contributed to the tax rate advantages or disadvantages that exist in each of the provinces in 2017.

Since the corporate tax rates on both SBD Income and ABI are well below the highest personal marginal tax rates (which range from 48% to 54% on ordinary income in 2017, depending on the province), there is also a tax deferral advantage on SBD Income and ABI.

Paying compensation from SBD Income

The majority of income for many small businesses will be SBD Income. Figure 2 shows the tax rate (dis)advantage and tax deferral advantage from distributing SBD Income as dividends, rather than salary, to an owner-manager who pays tax at the highest personal marginal tax rate.

Figure 1 – Theoretical and actual 2017 combined corporate tax rates on SBD Income and ABI

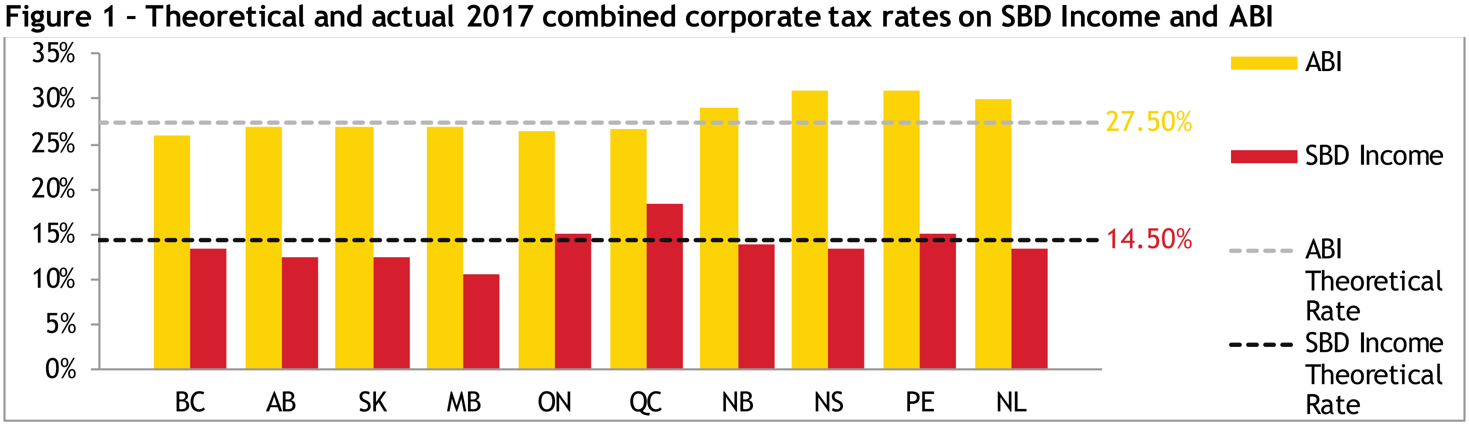

Figure 2 – Tax rate (dis)advantage and tax deferral advantage on SBD Income and ABI in 2017

Province	SBD Income		ABI	
	Tax Rate (Dis)advantage	Tax Deferral Advantage	Tax Rate (Dis)advantage	Tax Deferral Advantage
AB	(0.6%)	35.5%	(2.2%)	21.0%
BC	(0.6%)	34.7%	(1.5%)	21.7%
MB	(1.0%)	39.9%	(4.2%)	23.4%
NB	(0.2%)	39.3%	0.5%	24.3%
NL	0.1%	37.8%	(8.5%)	21.3%
NS	(0.1%)	40.5%	(5.7%)	23.0%
ON	0.0%	38.5%	(1.9%)	27.0%
PE	(0.9%)	36.4%	(3.2%)	20.4%
QU	(0.9%)	34.8%	(2.7%)	26.5%
SK	0.6%	35.5%	(1.1%)	21.0%

In 2017, there is a slight tax rate advantage on SBD Income in Saskatchewan (0.6%) and Newfoundland and Labrador (0.1%), so paying dividends will yield slightly higher proceeds to the shareholder than paying salary. In Ontario, there is no tax rate advantage or disadvantage, so paying salary or dividends will yield the same amount to the shareholder. In the other seven provinces, there is a slight tax rate disadvantage, ranging from 0.1% to 0.9%. This means that for distributions in 2017, salary compensation will be preferable dividend compensation in these seven provinces.

There is a significant tax deferral advantage in 2017 in all provinces that ranges from 34.7% to 40.5%. By choosing a dividend strategy in the three provinces where there is no tax rate disadvantage, the benefit from investing the deferred amount can enhance the amount available from the corporation. In the seven provinces where there is a tax rate disadvantage, if the benefit from investing the deferred amount will offset the incremental tax cost associated with deferral of dividends, then dividends should be paid in a later year. If not, salary should be paid in 2017.

Paying compensation from ABI

Now let's look at a corporation earning active business income that exceeds the small business deduction limit. Figure 2 illustrates the tax rate (dis)advantage and tax deferral advantage from distributing ABI as dividends, rather than salary, to an owner-manager who pays tax at the highest personal marginal tax rate.

In 2017 there is a tax rate disadvantage on ABI ranging from 1.1% to 8.5% in all provinces other than New Brunswick, which has a tax rate advantage of 0.5%. Consequently for distributions in 2017, salary compensation will be preferable in all provinces other than New Brunswick, where dividends will be nominally better.

There is a tax deferral advantage on ABI that ranges from 20.4% to 27.0% across the provinces, which may help to offset the cost of paying dividends in provinces other than New Brunswick. If the benefit from investing the deferred amount will offset the incremental tax cost associated with deferral of dividends, then dividends should be paid in a later year. If not, salary should be paid in 2017 in all provinces other than New Brunswick, where dividends should be paid.

Does the opportunity to make an RRSP contribution impact the compensation decision?

Distributing corporate income as a salary rather than dividends creates "earned income" that allows the owner-manager to contribute to an RRSP. The amount of the contribution is limited to 18% of earned income, so paying $145,722 of salary in 2017 may allow the owner-manager to make the maximum RRSP contribution of $26,230 in 2018.[5]

Paying salary beyond this level does not yield any additional RRSP contribution room, so RRSPs only affect the compensation decision when corporate income up to $145,722 is distributed to an owner-manager.

An RRSP allows the owner-manager to benefit from tax-sheltering on investment income (the "RRSP benefit.") In fact, when tax rates remain constant the owner-manager can effectively earn tax-free investment income on the net after-tax contribution to the plan, as described in my previous report Just Do It: The Case For Tax-free Investing.[6]

The RRSP benefit is higher when the rate of return on the underlying investments is higher or the time horizon is long, since both factors increase the amount of tax-free growth that can be accumulated in an RRSP. The RRSP benefit is also potentially greater for investment income that would be highly-taxed in a non-registered account (such as interest income or foreign dividends) than for income that would be more favourably taxed in a non-registered account (such as capital gains or Canadian dividends).

The higher the RRSP benefit, the more likely it is that paying salary to allow an RRSP contribution up to the contribution limit will be preferable to paying deferred dividends, since there is greater potential that the RRSP benefit associated with paying a salary and making an RRSP contribution will outweigh the tax deferral benefit associated with deferred dividends.

Many owner-managers may not be able to afford to leave 100% of the corporation's income in the company to enjoy the deferral advantage and must pay some of the corporation's earnings annually to meet current personal consumption needs. In these cases, paying a salary would permit the owner-manager to make an RRSP contribution and thus obtain the RRSP benefits discussed above on funds contributed to an RRSP.

Even for the owner-managers who do not need any of the corporation's earnings currently, paying a salary to permit the owner-manager to make an RRSP contribution may leave more for the shareholder than investing in the corporation and paying dividends. Additional information can be found in our report RRSPs: A Smart Choice for Business Owners.[7]

Other factors that influence the compensation decision

The analysis in this report has only considered the impact of the tax rate advantage, the tax deferral advantage and tax-sheltering benefits of an RRSP; however, there are other factors that can affect the compensation decision. For example, Canada Pension Plan premiums, Employment Insurance premiums and provincial employer health taxes (where applicable) may increase the cost of paying salary; however, these programs may also provide additional benefits to the owner-manager, such as CPP income. The report RRSPs: A Smart Choice for Business Owners[8] contains additional information about how these factors can affect the compensation decision.

Conclusion

When corporate income is to be distributed in 2017, such as when the owner-manager needs all funds in the current year, the 2017 tax rate (dis)advantage is a critical factor in the compensation decision. For SBD Income, paying salary is the best option due to the tax rate disadvantage in all provinces other than Saskatchewan and Newfoundland and Labrador, where paying dividends is marginally better, and Ontario where there is no difference. For ABI, paying salary is the best option due to the tax rate disadvantage in all provinces other than New Brunswick, where paying dividends is marginally better.

An owner-manager who does not need to withdraw corporate funds in 2017 must decide whether to take compensation currently or pay dividends in a future year. The tax deferral advantage affects this decision.

For both SBD Income and ABI, there is a significant tax deferral advantage coupled with a relatively small tax rate disadvantage in all provinces. This tends to favour the payment of deferred dividends, rather than distributing income in 2017, if investing the deferred amount in the corporation until dividends are paid would produce sufficient income to offset the relatively minor tax cost.

Due to the larger tax deferral on SBD Income than for ABI, deferred dividends are likely to be a better option for income below the small business deduction limit than for income above this threshold. When the benefit of tax deferral is not likely to outweigh the tax cost of paying dividends in a future year, compensation should be distributed in 2017 as described earlier.

While the tax deferral advantage and potential changes in the tax rate advantage strongly influence the decision to defer dividend payments, the ability to contribute to an RRSP complicates the analysis by making it more likely that salary would be a better option than deferred dividends. The owner-manager may wish to consider paying sufficient salary to maximize RRSP contributions, particularly if the RRSP invests in high-rate of return, highly-taxed investments over a long time horizon. Other factors, such as social security and provincial health program contributions and benefits, should also be considered.

Owner-managers should consult with a tax professional and a financial advisor for a complete analysis of all factors in the compensation decision.

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1 The report *Rethinking RRSPs for Business Owners* can be found online at www.jamiegolombek.com/media/jg-rethinking-rrsps-en.pdf.

2 The report *Bye Bye Bonus* can be found online at www.cibc.com/ca/pdf/jg-dividends-bonus-en.pdf.

3 All tax rates, tax rate (dis)advantages and tax deferral advantages in this report reflect all rate proposals announced up to December 31, 2016.

4 The small business deduction is available to Canadian-controlled private corporations (CCPCs) that earn active business income subject to the annual small business limit, which in 2017 is $500,000 federally and in all provinces other than Nova Scotia, where it is $350,000, and Manitoba, where it is $450,000.

5 Your 2018 RRSP deduction is limited to 18% of income earned in 2017, to a maximum of $26,230, less any pension adjustment plus any previous unused RRSP contribution room and any pension adjustment reversal.

6 The report *Just Do It: The Case For Tax-free Investing* can be found online at www.cibc.com/ca/pdf/case-for-taxfree-en.pdf.

7 The report *RRSPs: A Smart Choice for Business Owners* can be found online at www.cibc.com/content/dam/small_business/advice_centre/business-reports/RRSPs-for-business-owners-en.pdf.

8 Ibid.