The compensation conundrum: Will it be salary or dividends?

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When year-end approaches, as an owner-manager you may 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 your incorporated business in 2020 and beyond?

Integration and the compensation decision

If you run your businesses through a corporation[1], you can choose to receive compensation as either salary or dividends. If you choose salary compensation, you will pay personal tax on your salary income. Alternatively, if you choose dividend compensation, your company pays corporate tax when income is earned and you will pay personal tax when proceeds are distributed to you as a dividend. If there is "perfect integration", the amount of after-tax cash in your hands will be 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, there is tax savings (or tax cost) from paying dividends when the total corporate and personal tax paid on dividend compensation is less than (or more than) the personal tax paid on salary compensation.

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. There is tax deferral (or tax prepayment) from paying deferred dividends if the current corporate tax payable on corporate income is less than (or more than) the personal tax payable on salary. When there is tax deferral and corporate tax is less than personal tax, the deferred amount can be reinvested within your corporation to earn additional income until the dividend is ultimately paid, possibly many years later.

Our report Bye Bye Bonus[2] provides a more detailed explanation of the tax savings (tax cost) and tax deferral (tax prepayment).

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1 In this report, it is assumed that you are the sole shareholder of a corporation and you pay tax at the highest personal federal / provincial or territorial rate.

2 The report "Bye Bye Bonus" is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/jg-dividends-bonus-en.pdf.

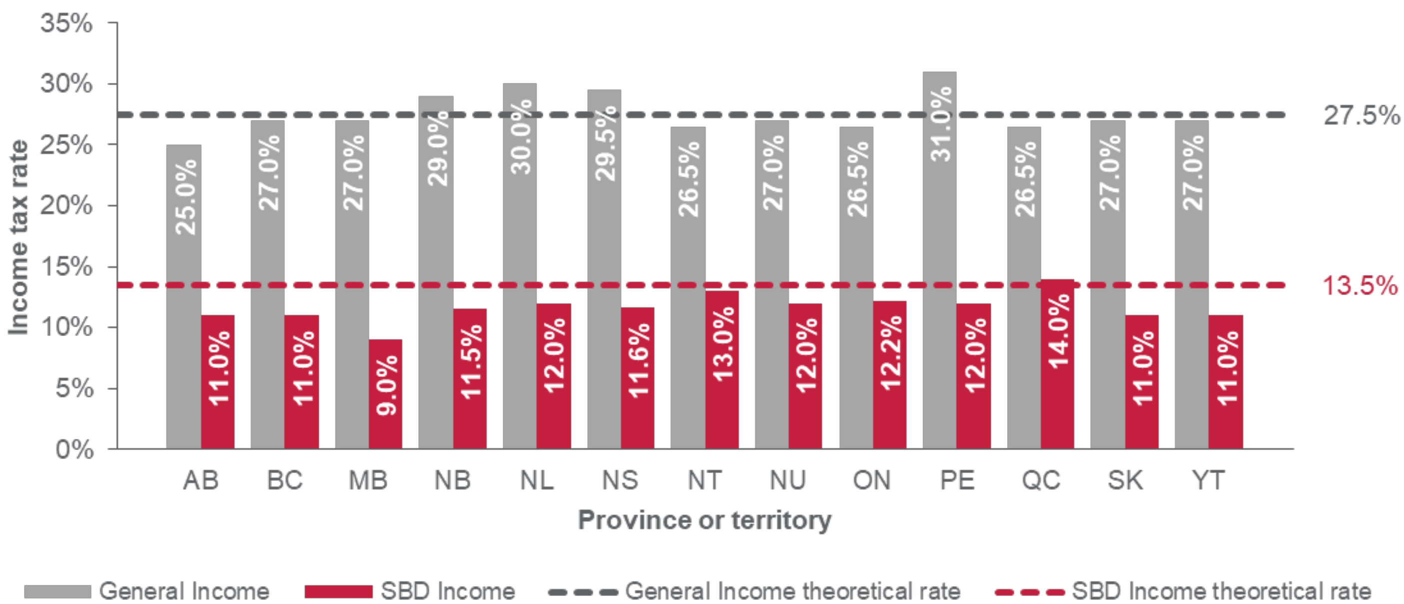
The evolution of integration

The integration system was originally based on a combined federal / provincial or territorial corporate tax rate of 20% but, in reality, corporate tax rates have seldom been equal to this theoretical rate.

For "SBD Income," which is active business income that qualifies for the small business deduction (SBD),[3] corporate tax rates have decreased over time. The 2020 corporate tax rates on SBD Income range between 9% and 14% in 2020, depending on the province or territory (illustrated in Figure 1). To better align with the actual corporate tax rates, since 2019 the federal integration system for non-eligible dividends has been based on a theoretical corporate tax rate of 13.5%. Your corporation can distribute its after-tax SBD Income to you as non-eligible dividends, and you can claim a personal dividend tax credit to compensate for the tax paid by your corporation.

"General Income," which includes active business income that does not qualify for the SBD, is taxed at rates between 25% and 31% in 2020, depending on the province or territory (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%. Your corporation can distribute its after-tax General Income to you as eligible dividends, and you can claim a higher personal dividend tax credit to compensate for the higher corporate tax rate.

Figure 1: Theoretical and actual 2020 combined corporate tax rates on SBD Income and General Income



Source: Tax Templates Inc., July 2020

Although using theoretical corporate tax rates of 13.5% for SBD Income and 27.5% for General Income 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).

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[3] 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 2020 is $500,000 federally and in all provinces and territories other than Saskatchewan where it is $600,000.

Choosing salary or dividends

The differences between theoretical tax rates and actual tax rates has contributed to the tax savings (or cost) that exists in each of the provinces and territories in 2020. Since the corporate tax rates on both SBD Income and General Income are well below the highest personal marginal tax rates (which range from 44.5% to 54% on ordinary income in 2020, depending on the province or territory), there is also tax deferral.

If you choose to have corporate income distributed in the year it is earned, such as when you needs funds for personal expenses, then the tax savings (or cost) 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, you should consider receiving deferred dividends. The tax deferral (or tax prepayment), as well as any changes in the tax savings (or cost) between the current year and year of dividend payment, help to determine whether to pay deferred dividends or pay compensation in the current year.

The majority of income for many small businesses will be SBD Income. Figure 2 shows the tax savings (or tax cost) and tax deferral from distributing SBD Income as dividends, rather than salary.

Figure 2: Tax savings (tax cost) and tax deferral on SBD Income and General Income in 2020 if the owner-manager pays tax at the highest personal marginal tax rate

Province or territory	SBD Income: Tax savings (tax cost)	SBD Income: Tax deferral	General Income: Tax savings (tax cost)	General Income: Tax deferral
AB	(0.65%)	37.00%	(0.52%)	24.01%
BC	(1.01%)	42.50%	(0.30%)	26.50%
MB	(1.07%)	41.40%	(4.27%)	23.40%
NB	(0.46%)	41.80%	0.51%	24.30%
NL	0.06%	39.30%	(8.53%)	21.30%
NS	(0.29%)	42.38%	(4.81%)	24.50%
NT	2.01%	34.05%	(0.40%)	20.55%
NU	(0.75%)	32.50%	(6.69%)	17.50%
ON	(0.59%)	41.33%	(2.01%)	27.03%
PE	(0.43%)	39.37%	(3.24%)	20.37%
QC	(1.24%)	39.30%	(2.78%)	26.80%
SK	0.57%	36.50%	(1.25%)	20.50%
YT	(0.53%)	37.00%	(0.25%)	21.00%

Source: Tax Templates Inc., July 2020

In 2020, there is slight tax savings on SBD Income in Newfoundland and Labrador, Nunavut and Saskatchewan, so receiving dividends would leave you with slightly higher proceeds than receiving salary. In the other ten provinces and territories, there is a slight tax cost, which means that for distributions in 2020, salary compensation will be preferable dividend compensation.

There is significant tax deferral in 2020 in all provinces, ranging from 32.5% to 42.5% for SBD Income. By choosing a dividend strategy in the three provinces where there is tax savings, the benefit from investing the deferred amount can enhance the amount available from the corporation. In the eight provinces where there is a tax cost, 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; otherwise, salary should be paid in 2020.

Compensation from General Income

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

Figure 2 shows that in 2020 there is tax cost on General Income ranging from 0.25% to 8.53% in all provinces and territories other than New Brunswick. Consequently for distributions in 2020, salary compensation will be preferable in all provinces other than New Brunswick, where dividends will be nominally better.

There is tax deferral on General Income ranges from 17.50% to 27.03% across the provinces and territories, 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 2020 in all provinces other than New Brunswick, where dividends should be paid.

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

Receiving salary rather than dividends from your corporation creates "earned income" that allows you to contribute to an RRSP. Your contribution is limited to 18% of your earned income in the prior year, so receiving $154,611 of salary in 2020 may allow you to make the maximum RRSP contribution of $27,830 in 2021.[4]

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 $154,811 is distributed to you.

An RRSP allows you to benefit from tax deferral on investment income. In fact, when tax rates remain constant you can effectively earn a tax-free rate of return on your RRSP, as described in our report Just Do It: The Case For Tax-free Investing.[5]

The benefit from RRSP investing 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 you can accumulate in an RRSP. The 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).

Many owner-managers may not be able to afford to leave 100% of income in their companies to enjoy the tax deferral and must pay some of the corporation's earnings annually to meet their current personal 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. 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 be less advantageous. Additional information can be found in our report RRSPs: A Smart Choice for Business Owners.[6]

Other factors that influence the compensation decision

The analysis in this report has only considered the impact of the tax savings (tax cost) and the tax deferral with corporate investing or personal investing in 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, such as CPP income. The report RRSPs: A Smart Choice for

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4 Your 2021 RRSP deduction is limited to 18% of income earned in 2020, to a maximum of $27,830, less any pension adjustment plus any previous unused RRSP contribution room and any pension adjustment reversal.

5 The report "Just Do It: The Case For Tax-free Investing" is available online at cibc.com/content/dam/personal_banking/advice_centre/start_savings_plan/pdfs/case-for-taxfree-en.pdf.

6 The report "RRSPs: A smart choice for business owners" is available online at cibc.com/content/dam/small_business/advice_centre/business-reports/RRSPs-for-business-owners-en.pdf.

Business Owners[7] contains additional information about how these factors can affect your compensation decision.

Conclusion

When corporate income is to be distributed in 2020, such as when you need funds in the current year, the 2020 tax savings (tax cost) is a critical factor in your compensation decision. For SBD Income, there is slight tax savings in Newfoundland and Labrador, Nunavut and Saskatchewan, so you would receive slightly higher proceeds with dividends than with salary; in the other ten provinces and territories, salary compensation will be marginally better than dividend compensation. For General Income, receiving salary is the best option due to the tax cost in all provinces other than New Brunswick, where paying dividends is marginally better.

If you do not need to withdraw corporate funds in 2020, you must decide whether to take compensation currently or have your company pay dividends in a future year. The tax deferral affects this decision.

For both SBD Income and General Income, there is a significant tax deferral coupled with a relatively small tax savings or tax cost in all provinces. This tends to favour the payment of deferred dividends, rather than distributing income in 2020, if the deferred amount can be invested in your corporation to produce sufficient income to offset the relatively minor tax cost (where applicable).

Due to the larger tax deferral on SBD Income than for General Income, deferred dividends are likely to be a better option for income below the SBD limit than for income above this threshold. When income from investing the tax deferral amount is not likely to outweigh the tax cost of paying dividends in a future year, compensation should be distributed in 2020 as described earlier. While the tax savings (tax cost) and tax deferral strongly influence the decision to defer dividend payments, you may wish to consider receiving salary so you can contribute to an RRSP, particularly if you need funds for personal expenses. Other factors, such as social security and provincial health program contributions and benefits, should also be considered.

You should consult with a tax professional and a financial advisor for a complete analysis of all factors in your compensation decision.

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7 Ibid.