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?

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.

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.

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.

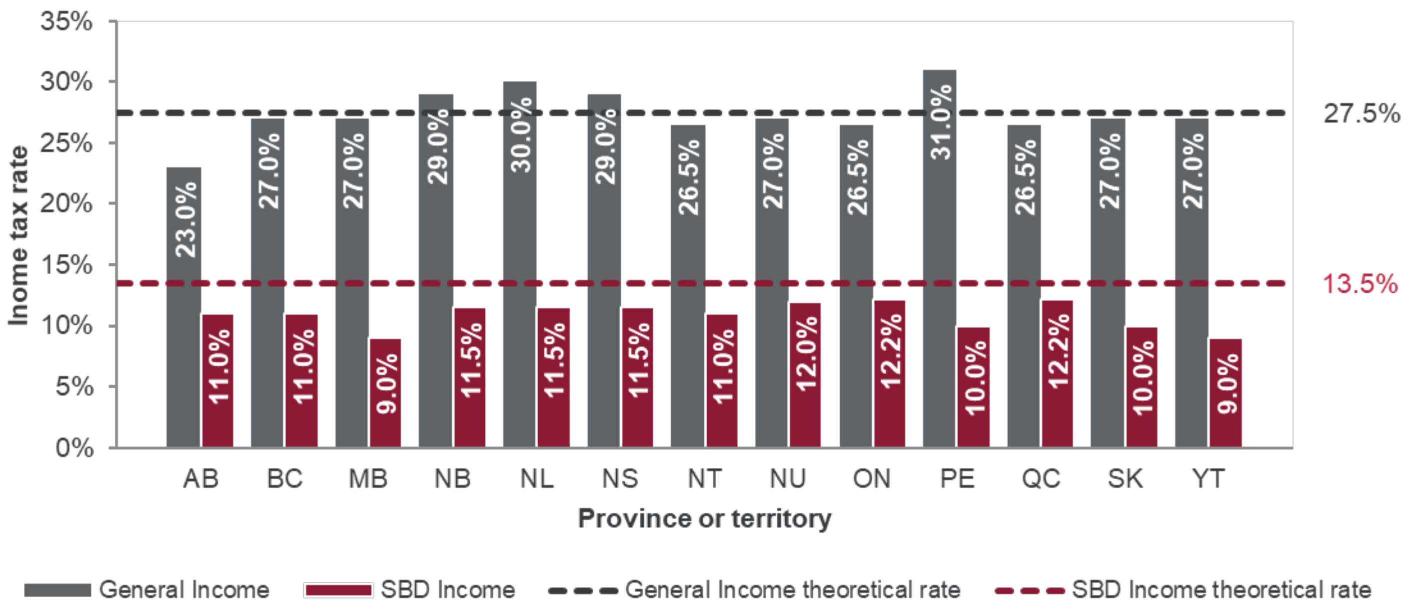
Regardless of whether or not perfect integration exists, there may still be a benefit from deferring payment of dividends to a future year since corporate tax on business income is payable in the current year but personal tax on the dividend is paid in a future year. There is Tax Deferral (or Tax Prepayment) 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! Why business owners may prefer dividends over a bonus provides a more detailed explanation of the Tax Savings (Tax Cost) and Tax Deferral (Tax Prepayment).

The evolution of integration

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

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



Source: Tax Templates Inc.

For "SBD Income," which is active business income that qualifies for the small business deduction (SBD),[2] corporate tax rates have decreased over time. The corporate tax rates on SBD Income range between 9.0% and 12.2%, 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.

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2 The small business deduction is available to Canadian-controlled private corporations (CCPCs) that earn active business income subject to the annual small business deduction limit (SBD Limit), which is $500,000 federally and in all provinces and territories other than Saskatchewan where it is $600,000. The federal SBD Limit is reduced on a straight-line basis for associated corporations with taxable capital between $10 million and $50 million. The federal SBD Limit for CCPCs is also reduced by $5 for each $1 of "adjusted aggregate investment income" (AAII) that exceeded $50,000 in the previous year, and reaches zero once $150,000 of AAII is earned in the previous year.

“General Income,” which includes active business income that does not qualify for the SBD, is taxed at rates between 23% and 31%, 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.

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).

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 . 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 54.8% on ordinary income , 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 need 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 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%	(1.82%)	25.00%
BC	(1.01%)	42.50%	(0.30%)	26.50%
MB	(1.07%)	41.40%	(4.27%)	23.40%
NB	(0.44%)	41.00%	0.49%	23.50%
NL	(0.03%)	43.30%	(7.54%)	24.80%
NS	(0.23%)	42.50%	(4.52%)	25.00%
NT	3.28%	36.05%	(0.40%)	20.55%
NU	(0.75%)	32.50%	(6.69%)	17.50%
ON	(0.59%)	41.33%	(2.01%)	27.03%
PE	(1.12%)	41.75%	(4.23%)	20.75%
QC	(1.65%)	41.10%	(2.80%)	26.80%
SK	0.29%	37.50%	(1.26%)	20.50%
YT	(1.08%)	39.00%	(0.27%)	21.00%

Source: Tax Templates Inc.

There is slight Tax Savings on SBD Income in the Northwest Territories and Saskatchewan, so receiving dividends would leave you with slightly higher proceeds than receiving salary. In the other eleven provinces and territories, there is a slight Tax Cost, which means that for distributions, salary compensation will be preferable dividend compensation.

There is significant Tax Deferral in all provinces, ranging from 32.5% to 43.3% 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 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 the current year.

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 there is Tax Cost on General Income ranging from 0.27% to 7.54% in all provinces and territories other than New Brunswick. Consequently for distributions in the current year, salary compensation will be preferable in all provinces other than New Brunswick, where dividends will be nominally better.

The 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 the current year in all provinces other than New Brunswick, where dividends should be paid.

Does the opportunity to make an RRSP or TFSA 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 $180,500 of salary in 2024 may allow you to make the maximum RRSP contribution of $32,490 in 2025.[3] 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 $180,500 is distributed to you.

You automatically accumulate Tax Free Savings Account (TFSA) contribution room for each year after 2008 in which you are at least 18 years old and resident in Canada. The TFSA dollar limit is $7,000 for 2024. TFSA contribution room is cumulative and unused room is carried forward indefinitely to future years. If you have been resident in Canada and at least 18 years old since 2009 and, as of 2024, have not yet contributed to a TFSA, you can immediately contribute $95,000 to a TFSA. Unlike an RRSP, you do not need earned income to make a TFSA contribution.

An RRSP or TFSA 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 or TFSA, as described in our report Just Do It: The Case For Tax-free Investing.

The benefit from RRSP or TFSA 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 or TFSA. 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 or TFSA contribution and

[3] Your 2024 RRSP deduction is limited to 18% of income earned in 2023, to a maximum of $31,560, less any pension adjustment plus any previous unused RRSP contribution room and any pension adjustment reversal.

thus obtain the benefits discussed above on funds contributed to an RRSP or TFSA. 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 or TFSA contribution may be less advantageous. Additional information can be found in our report RRSPs and TFSAs: Smart choices for business owners.

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 (CPP) or Quebec Pension Plan (QPP) 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 or QPP income. The report RRSPs and TFSAs: Smart choices for business owners contains additional information about how these factors can affect your compensation decision.

Conclusion

When corporate business income is to be distributed in the current year, the Tax Savings (Tax Cost) is a critical factor in your compensation decision. For SBD Income, there is slight Tax Savings in the Northwest Territories 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 business income in the current year, 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 the current year, 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 the current year 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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