December 2013

The Compensation Conundrum: Will it be salary or dividends?

by Jamie Golombek

With the year-end for most businesses fast approaching, owner-managers once again will 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 that will take effect in 2014. Given these changes, what is the best remuneration strategy for a small business in 2013 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" 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.

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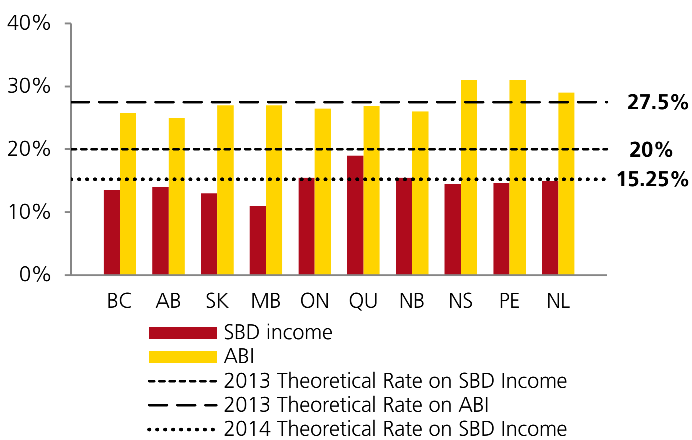
If corporate income will be distributed in the year it is earned, such as when the owner-manager needs funds for personal expenses, then the tax rate advantage is a key factor when choosing to compensate by dividends or salary. If corporate income does not necessarily need to be distributed in the current 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]

Figure 1 – Theoretical and actual 2013 combined corporate tax rates on SBD Income and ABI



For SBD Income, which is active business income up to the small business deduction limit ($500,000 federally and in most provinces), corporate tax rates have decreased over time. The 2013 combined federal/provincial corporate tax rates on SBD Income range from about 11% to 19% (illustrated in Figure 1), which is lower than the theoretical rate of 20%. To better align with the actual corporate tax rates, starting in 2014 the federal integration system for non-eligible dividends will be based on a theoretical corporate tax rate of 15.25%.

For ABI, which is active business income exceeding the small business deduction limit, the 2013 combined federal/provincial corporate tax rates range from about 25% to 31% (illustrated in Figure 1). The system of eligible dividends was introduced to take these higher corporate tax rates into account and is based on a theoretical corporate tax rate of 27.5% in 2013. 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 15.25% for SBD Income and 27.5% for ABI helps to align the integration systems better than the 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 for both 2013 and 2014.

Since the corporate tax rates on both SBD Income and ABI are well below the highest personal marginal tax rates (which range from 39% to 50% on ordinary income in 2013, depending on the province), there is also a tax deferral advantage on SBD Income and ABI in 2013.

Paying Compensation from SBD Income

The majority of income for many small businesses will be SBD Income. Figure 2 illustrates 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.

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

2 *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 November 8, 2013.

Figure 2 – Tax rate (dis)advantage and tax deferral advantage on SBD Income in 2013 and 2014

	2013		2014	
Province	Tax Rate (Dis)-advantage	Tax Deferral Advantage	Tax Rate (Dis)-advantage	Tax Deferral Advantage
AB	1.17%	25.00%	(0.69%)	25.00%
BC	1.04%	30.20%	(0.56%)	32.30%
MB	0.56%	35.40%	(0.89%)	35.40%
NB	1.65%	29.57%	0.91%	31.34%
NL	1.84%	27.30%	0.94%	27.30%
NS	4.54%	35.50%	2.40%	36.00%
ON	3.21%	34.03%	0.12%	34.03%
PE	(0.18%)	32.73%	(1.95%)	31.87%
QU	(0.25%)	30.97%	(1.26%)	30.97%
SK	2.00%	31.00%	0.27%	31.00%

In 2013, there is a tax rate advantage on SBD Income ranging from 0.56% to 4.54% in all provinces other than P.E.I. and Quebec, where there is a slight tax rate disadvantage of 0.18% and 0.25% respectively. This means that for distributions in 2013, dividend compensation will be preferable to salary compensation in all provinces except for P.E.I. and Quebec, where salary is nominally better.

If SBD Income does not need to be distributed in the year it is earned, there will be an incremental tax cost if dividends are paid in 2014, rather than 2013. For example, in Ontario the tax rate advantage will decrease from 3.21% in 2013 to 0.12% in 2014, due to changes in the taxation of non-eligible dividends and the proposed changes to the calculation of the Ontario dividend tax credit. As a result, there would be an incremental tax cost of 3.09% (0.12% - 3.21%) if a dividend payment were delayed by just one year.

Although the cost of paying dividends will be higher in 2014 (and beyond if tax rates remain unchanged), there is a significant tax deferral advantage in 2013 in all provinces that may help to offset the incremental cost. The tax deferral advantage ranges from 25.00% to 35.50% across the provinces in 2013. 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, dividends should be paid in 2013 (other than P.E.I. and Quebec, where salary should be paid in 2013).

Paying Compensation from ABI

Now let's look at a corporation earning active business income that exceeds the small business deduction limit. Figure 3 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.

Figure 3 – Tax rate (dis)advantage and tax deferral advantage on ABI in 2013 and 2014

	2013		2014	
Province	Tax Rate (Dis)-advantage	Tax Deferral Advantage	Tax Rate (Dis)-advantage	Tax Deferral Advantage
AB	(0.47%)	14.00%	(0.47%)	14.00%
BC	(1.19%)	17.95%	(1.42%)	19.80%
MB	(4.15%)	19.40%	(4.15%)	19.40%
NB	0.63%	19.06%	(0.13%)	19.84%
NL	(2.65%)	13.30%	(2.65%)	13.30%
NS	(5.88%)	19.00%	(5.88%)	19.00%
ON	(1.85%)	23.03%	(1.83%)	23.03%
PE	(3.44%)	16.37%	(3.44%)	16.37%
QU	(2.68%)	23.07%	(2.68%)	23.07%
SK	(1.11%)	17.00%	(1.11%)	17.00%

In 2013 there is a tax rate disadvantage on ABI ranging from 0.47% to 5.88% in all provinces other than New Brunswick, which has a tax rate advantage of 0.63%. Consequently for distributions in 2013, salary compensation will be preferable in all provinces other than New Brunswick, where dividends will be nominally better.

If ABI does not need to be distributed in the year it is earned, the cost from the tax rate disadvantage in 2014 will be essentially the same as 2013 in all provinces other than in British Columbia and New Brunswick, where there will be an additional cost for distributing dividends in 2014.

Although there will be a tax cost when dividend payments are delayed beyond 2013, there is a tax deferral advantage on ABI that ranges from 13.30% to 23.07% across the provinces, which may help to offset the 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. If not, salary should be paid in 2013 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 $134,833 of salary in 2013 will allow the owner-manager to make the maximum RRSP contribution of $24,270 in 2014. 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 $134,833 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*.[4]

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. But for the owner-managers who do not need any of the corporation's earnings currently, choosing to leave all these earnings in the company in favour of paying deferred dividends at a later date can be advantageous, provided the time horizon is long enough due to the substantial tax deferral advantage discussed above. This was modelled in our report *Rethinking RRSPs for Business Owners*.[5]

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 R*ethinking RRSPs for Business Owners*[5] contains additional information about how these factors can affect the compensation decision.

CONCLUSION

When corporate income is to be distributed in 2013, such as when the owner-manager needs all funds in the current year, the 2013 tax rate advantage is a critical factor in the compensation decision. For SBD Income, paying dividends is the best option due to the tax rate advantage in all provinces other than Quebec and P.E.I, where paying salary is better. 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 better.

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

[5] *Rethinking RRSPs for Business Owners* can be found online at www.cibc.com/ca/pdf/jg-rethinking-rrsps-en.pdf.

An owner-manager who does not need to withdraw corporate funds in 2013 must decide whether to take compensation currently or pay dividends in a future year. Both the tax deferral advantage and any potential changes in the tax rate advantage in future years affect this decision. For both SBD Income and ABI, there is a significant tax deferral advantage coupled with a relatively small (incremental) tax rate disadvantage from 2013 to 2014 in all provinces. This tends to favour the payment of deferred dividends, rather than distributing income in 2013, 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 2013 as described in the previous paragraph.

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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