Integration of Corporate and Personal Income taxes

As an accountant one of the areas that I have found to cause stress amongst my "Canadian controlled private corporation" ("CCPC") clients is "how should I remunerate myself' to achieve tax efficiency. They like hearing that the corporate rate is 15.5%, (Ontario combined Federal and Provincial rates for active taxable income less than $500K) but are often dismayed to find out that when funds are distributed by way of dividends a personal tax cost is incurred. They often question, "am I not paying overall more tax by paying the corporate tax then taking the balance out by a dividend"? The simplistic answer is no. That is, most business owners should be indifferent in choosing between salary and dividends from an overall tax perspective. However, for those with a desire to take advantage of Registered Retirement Savings Plan ("RRSP") contributions, salary remuneration is required.

The Canadian tax system is designed so an individual should be indifferent between earning income though a Canadian corporation by salary or dividend.

To avoid an increased overall tax burden or "double taxation" on the income earned by a corporation there is a gross-up and dividend tax credit mechanism (issued by T5 slips). This system provides recognition for the corporate taxes already paid, to the taxable residents in Canada who receive these dividends. Dividends on T5 slips are classified as "eligible" or "non eligible":

- Non-eligible dividends have a "gross-up” of the actual dividend figure and a tax credit to reflect the corporate tax paid that was eligible for the small business tax rate.
- Eligible dividends have a "gross-up" of the actual dividend figure and a tax credit to reflect the corporate tax paid for CCPE's not eligible for the small business tax rate or other Canadian corporations that pay tax at the higher corporate rates.

"Flowing-out" income from a company by way of “salary versus dividends", theoretically a business owner should be indifferent. The following 2 charts on the next page analyze this concept.

I. "Flow-out" of Company income subject to the Small Business tax rate (Chart I)

	Flow out by	
	Salary	Dividend
Company:		
Company earns, taxable income	$1,000	$1,000
Salary	(1,000)	-
Taxable income	-	1,000
*Taxes – 15.5%	-	155
Funds in Company	$ -	$ 845
*Personal taxes		
Salary	$1,000	$ -
Dividend – "ineligible"	-	845
*Taxes (46.41% (S) – 32.57% (D))	(464)	(275)
Funds after distribution	$ 536	$ 570
Taxes:	$ -	$ 155
Company	464	275
Personal	$ 464	$ 430

II. "Flow-out" of Company income not subject to the Small Business tax rate (Chart II)

	Salary	Dividend
Company:		
Company earns, taxable income	$1,000	$1,000
Salary	(1,000)	-
Taxable income	-	1,000
*Taxes – 26.5%	-	265
Funds in Company	$ -	$ 735
*Personal taxes		
Salary	$1,000	$ -
Dividend – "ineligible"	-	735
*Taxes (46.41% (S) – 32.57% (D))	(464)	(217)
Funds after distribution	$ 536	$ 518
Taxes:	$ -	$ 265
Company	464	217
Personal	$ 464	$ 482

**Assuming highest marginal tax rate for resident of Ontario, (but not $500K personal threshold additional Ontario tax) and Ontario corporate rates.*

Chart I Conclusion

In Ontario (and most other provinces to varying degrees) there is a tax savings of $34 ($464-$430) on every $1,000 the Company earns by paying out dividends versus salary, or 3.4%.

Chart II Conclusion

In Ontario (and most other provinces to varying degrees) there is a tax cost of $18 ($464-$482) on every $1,000 the Company earns by paying out dividends versus salary, or 1.8%.

The Tax Deferral Opportunity of Maintaining Funds in the Company

My experience is that a high percentage of clients, in the service industry, distribute to themselves most of what the Company earns on an annual basis. However, there is a significant tax deferral advantage if funds can be maintained in the corporation. With the deferral, there is then a greater level of funds to invest, versus taking the funds "out", paying the personal tax then investing.

Going back to Chart I, it can be seen that if funds are maintained in the corporation there is $845 available for investment versus either $536 or $570 if funds are distributed to the individual. The compounding benefit of investing these “tax deferred” funds, similar to RRSP funds, can be significant.

Going back to Chart II, it can be seen that if funds are maintained in the corporation there is $735 available for investment versus either $536 or $518. The compounding benefit of investing these funds should, of course subject to investment returns, offset the slight (1.8%) disadvantage of ultimately distributing the funds by a dividend, in a relatively short time.

The change in rules by CRA with respect to the classification of dividends as "eligible" or "non-eligible" was in response to Canadian corporations converting to income trust structures. Corporations were converting to income trusts, to eliminate the existing, at the time, “double taxation". This resulted when corporations paying the high corporate tax rate distributed, by dividends, their after tax income. Though there was still a tax deferral on paying the corporate tax and leaving funds in the corporation, the number of years of "investment gain" to offset this figure was significant, of course subject to investment returns. Therefore, “bonusing” down to the small business tax rate limit (was $200K raised to present $500K figure) was generally the preferred tax plan, for CCPCs. Based on the above analysis, unless funds are fully distributed in the current year, bonusing down to the small business tax limit is no longer the preferred plan.

Other issues

• No RRSP contribution room if remuneration by way of dividends

Dividends are not considered "earned income" so this form of remuneration does not earn "room" that allows for RRSP contributions. The question "is it better to take remuneration by salary, pay greater personal tax, but then contribute to a RRSP"? This analysis is complicated. However, the tax deferred and actual tax benefits by maintaining funds in the corporation, taxed at the small business rates, can potentially outweigh the tax-free investment returns made within a RRSP. However, to “focus” investment strategy, annual contributions to a RRSP seems preferred. Therefore, receiving a salary at a level to maximize the RRSP contribution room figure seems to make sense, or up to approximately $128,000 with the balance of remuneration as dividends (for small business taxed income).

Conclusion

Though dividend remuneration provides a small overall tax benefit by "flowing out" funds earned in this manner, this benefit is "negated" by the fact RRSP contribution room is not earned. Thus the tax benefit of RRSP deductions is lost if remuneration by dividends.

• Asset protection and potential loss of the $750K lifetime capital gains exemption ("LCG")

The LCG is available for disposition of qualified small business corporation shares. To be eligible certain asset tests must be achieved. If significant investments not active to the business are built-up, then on the sale of the shares the shareholder may not have access to the LCG.

In any case, for "asset protection", to ensure investments are not exposed to liabilities of the corporation through its active businesses, it is generally desirable to hold investments in a "holding" company concept.

The above discussion applies to companies of all sizes.

A significant issue that affects smaller consulting companies, may change much of the tax planning discussion above. In October 2011 the Federal Government proposed amendments to the Income Tax Act which would apply to companies deemed to be a Personal Service Business. These proposed changes would apply to situations where the government was trying to "deal with situations where a corporation has been interposed between a service recipient and an individual that has been otherwise constituted an employer-employee relationship".

In such instances, the government's goal was to disallow all expenses which were not available to an employee and eliminate or make unreasonable the option of deferring the taxation of income as dividends, effectively requiring the contractor to declare all income in the year that it was earned.

However, that is a discussion for another day.

Of course no plan should be implemented without proper professional advice.

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