Integration of Corporate and Personal Income taxes

One of the areas that causes stress amongst "Canadian controlled private corporation" ("CCPC") clients is "how should they remunerate themselves to achieve tax efficiency. They generally 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 present 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 The Income Tax Act uses a gross-up and dividend tax credit mechanism (issued on 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 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 – 15.0%	-	150
Funds in Company	$ -	$ 850
*Personal taxes		
Salary	$1,000	$ -
Dividend – "ineligible"	-	850
*Taxes (53.53% (S) – 45.30% (D))	(535)	(385)
Funds after distribution	$ 465	$ 465
Taxes:	$ -	$ 150
Company	535	385
Personal	$ 535	$ 535

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 – "eligible"	-	735
*Taxes (53.53% (S) – 39.34% (D))	(535)	(289)
Funds after distribution	$ 465	$ 446
Taxes:	$ -	$ 265
Company	535	281
Personal	$ 535	$ 554

**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 no tax savings or cost on every $1,000 the Company earns by paying out dividends versus salary

Chart II Conclusion

In Ontario (and most other provinces to varying degrees) there is a tax cost of $19 (535 – 554) on every $1,000 the Company earns by paying out dividends versus salary, or 1.9%.

Tax Deferral Possibility

Our 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. Typically Contractors require just as much in the way of income after they pay for all their expenses and mandated government premiums as full time employees to live. 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 $850 available for investment versus either $465 or $525 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 $465.

It should be noted that there is a 1.9% disadvantage when the funds are distributed as salary versus by a dividend.

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 receiving a salary at a level to maximize the RRSP contribution room figure seems to make sense, or up to approximately $143,000 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 exemptions (“LCG”)

<u>Asset Protection</u>

Active business can be subject to risk of claim by litigants. It is generally desirable to hold investments in a "holding" company concept. , for “asset protection, to ensure investments are not exposed to potential claims by litigants through its active business activities.

The above discussion applies to companies of all sizes.

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