THE Great-West Life ASSURANCE COMPANY

Retirement income: Planning for business owners

Business owners always face the question of how to pay themselves. It's a big decision once you factor in the tax situation and potential impact to retirement plans and lifestyle.

Considerations

Business owners usually have professionals they rely on to help them make day-to-day decisions regarding their business, financing, tax situation and legal affairs.

Some care needs to be taken to ensure decisions being made take the business owner's entire situation into account, including the future. Many professionals are focused on current issues and provide solutions appropriate for today. The question for business owners to ask is, "How can I best make sure my entire life cycle is being considered when I'm planning for the future?"

The professional may be advising the client how to minimize tax, for example, but not giving consideration to how the solution may affect the individual later on in life. It's not the responsibility of the tax professional to plan for an individual's retirement also – this is where the services of a financial security advisor come into play.

Business owners are generally very good at the business they run, but are less savvy when it comes to the maintenance and planning around the business or their financial affairs.

One of the most common decisions business owners have to weigh is how to pay themselves from their business.

Dividend, salary or leave it in the corporation?

There is no right or wrong answer. It depends on factors such as individual circumstances, preferences, retirement planning and financial discipline.

There are a number of thoughts…

- Some accountants suggest the bonus-down approach. The object is to reduce corporate income below the small business limit by paying a bonus to avoid the high rate of tax in the corporation. The bonus is taxed to the business owner the same as salary. Any additional money required (or desired) from the corporation would usually be paid as a dividend.

- Other accountants argue that the tax rate on dividends from a small business is less than the tax rate of salary; they suggest total remuneration by dividend for absolute tax savings.
- Many accountants suggest clients pay themselves enough salary to maximize their Canada pension plan (CPP) or Quebec pension plan (QPP) contributions, and if possible, to maximize earned income that is the determining factor for registered retirement savings plan (RRSP) contributions.
- The last option, if money wasn't needed by the business owner for his or her lifestyle, is to leave the money in the corporation and only pay the small business tax rate, thus deferring personal tax to the future.

Advantage of taking dividends

The tax rate of dividend income is less than the tax rate of salary or regular income. Further, dividend income is not subject to payroll taxes such as CPP/QPP, employment insurance (EI), employer health tax (EHT) or workplace safety and insurance board (WSIB). The after-tax amount in the business owner's hands is more than if the same amount was paid as salary.

Disadvantage of paying only dividends

The most apparent disadvantage of paying only dividends from the corporation is there are no contributions being made to CPP/QPP. This means no CPP/QPP retirement benefit later in life. Many individuals value CPP/QPP benefits and view their contribution to these plans as an investment for their retirement, not an expense.

Another disadvantage is that dividend income does not generate earned income for tax purposes and therefore does not create RRSP contribution room. Unless the business owner has other sources of income that create earned income, he or she will not be able to contribute to an RRSP. This may have a direct impact on retirement income planning. While they can invest the income tax and payroll tax savings they get from paying a dividend in a non-registered account or tax-free savings account (TFSA), these options have limitations. Generally:

- Investments in a non-registered account do not provide tax-deferred growth similar to an RRSP.
- The legislated contribution limits for a TFSA may restrict the amount they can invest for retirement.

A plan may be designed to attempt to invest the difference between taxes payable and contributions in the different scenarios, but a lack of financial discipline could have an impact. Let's face it: Many of us have a long wish list – things we would like to buy or places we would like to visit if we just had a little more money available.

People are more likely to spend the extra cash they have or withdraw it from the non-registered account or TFSA than they would from a RRSP. An invisible barrier seems to exist when people think about withdrawing from their RRSPs because of the immediate tax consequences. The end result is a higher possibility of shortfall in retirement income planning if investments are not in an RRSP.

There are other tax-related disadvantages:

- Individuals who incur childcare expenses cannot deduct these expenses from dividend income. If the individual has income from employment or the business, the deduction is available.

- The dividend gross-up increases total income; for individuals receiving old age security (OAS) this may increase the risk of triggering the OAS recovery tax (“clawback”).

Corporate planning

Business owners who choose to leave the money in their corporations generally do not plan to use that money either. This money, if for retirement, should be invested appropriately with the proper time horizon and appropriate risk tolerance of the individual, not the corporation.

Creditor protection may be an issue if excess income not withdrawn from the corporation is left inside the company. It may be exposed to the claims of the corporation’s creditors. To protect these funds, the business owner may need to establish a holding company or trust to distribute the excess cash out of the operating company. Both options have their own costs and benefits, the discussion of which is beyond the scope of this article. From the perspective of the discussion of paying dividends or salary, keep in mind additional planning may be required or corporate funds may be subject to creditor claims.

Case study

Let’s assume that in 2014, a corporation eligible for the small business deduction has income of $100,000 before income taxes, and remuneration to the business owner. The business owner is deciding between paying the corporate tax on the $100,000 of income and the remaining amount as dividend; or paying the entire amount as salary.

Assumptions

Salary is fully deductible to the corporation so no taxable income remains in the corporation and therefore no corporate income tax would result. To make the comparison more meaningful, further assume that the business owner has RRSP contribution room of $17,576[1]. The business owner maximizes his RRSP contribution each year, and the tax rate when the RRSP contribution is withdrawn is 25 per cent.

Corporate tax calculation	**Ontario**	
	Dividend	Salary
Income	100,000	100,000
Salary	-	(97,574)
CPP employer contribution	-	(2,426)
Taxable income	100,000	-
Corporate tax rate	15.50%	15.50%
Corporate tax	15,500	-
Dividend available	**84,500**	**-**
Personal tax calculation		
Grossed-up dividend Income	99,710	-
Salary income	-	97,574
RRSP deduction	-	(17,576)
Taxable income	99,710	79,998
Income tax (2014 tax rates)	(11,592)	(18,088)
Personal CPP contribution	-	(2,426)
	88,118	59,484
Dividend gross-up	(15,210)	-
Cash to business owner	**72,908**	**59,484**
RRSP contribution	-	17,576
Tax on RRSP withdrawl in future @ 25%		(4,394)
Total cash and RRSP investment	**72,908**	**72,666**
Next year's RRSP contribution room		17,563

Only basic exemption, CPP/QPP & employment amount considered
Used Ontario rates for an example

[1] ($100,000 less the corporate portion of the 2013 CPP contribution) multiplied by 18 per cent.

In the example, the cash available on an annual basis is greater if the money is paid as a dividend rather than salary. But this conclusion does not consider the following:

- RRSP contribution, and the tax-deferred growth
- CPP/QPP contributions and potential CPP/QPP benefit until death

While the potential CPP/QPP benefit and growth of the RRSP may be difficult to predict, the illustration is enhanced to consider the RRSP contribution, net of tax, when it is withdrawn in future.

Once factored in, both alternatives provide a comparable result; however, the salary option may also provide tax-deferred RRSP growth and CPP/QPP benefit until death.

Conclusion

There is no rule-of-thumb solution for dividends or salary. In some cases, paying dividends provides more cash flow; while in other cases paying salary provides more cash flow. In other cases, the payment of a combination of dividends and salary may provide better results. It may be in your client's best interest to question any advice received relating to the payment of dividends or salary. It's important to consider the individual's circumstances and retirement planning objectives.