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## **Bye-bye Bonus! Why small business owners may prefer dividends over a bonus**

*Traditionally, many Canadian small business owners have been advised to pay themselves either a salary or, at the very least, “bonus down” to the small business deduction level or face punitively high corporate tax rates on income not eligible for the preferred small business tax rates. But, a renewed look at the theory of integration, which examines both current corporate income tax rates as well as ever-changing personal tax rates on dividends, would suggest that in many cases, dividends may be the preferred method of remuneration for incorporated small business owners in 2011.*

With 2011 coming to a close, small business owners soon need to make some important decisions as to how they should be compensated for their efforts: bonus or dividends. The decision involves taking a close look at the theory of integration, the 2011 corporate and personal tax rates, and the potential deferral advantage of leaving funds in the corporation when they are not currently needed to fund lifestyle cashflow requirements.

In this report, we will revisit the theory of integration, taking a close look at the salary/bonus vs. dividends decision in theory and in practice, with a focus on 2011 tax rates. We will then examine the tax rate advantage and the tax deferral advantage to conclude that in many cases it makes sense to have corporate income, whether eligible for the small business deduction or not, taxed inside the corporation rather than paid out as a bonus, assuming the funds are not needed immediately for consumption. This tax deferral advantage will be quantified in two examples illustrating the value of the deferral over a number of years. Finally, we will take a look at a few other considerations of saying goodbye to the annual bonus in favour of a dividends-only compensation plan.

### **Theory of Integration**

The Canadian income tax system is designed in such a way that an individual should be indifferent between earning income personally or through a private corporation. In other words, an individual should pay the same amount of total tax on income whether earned personally or earned through a corporation, taxed at the corporate level and then paid out as a dividend to be taxed in the shareholder’s hands. This is known as the theory of integration.

### **Salary vs. Dividends**

Under perfect integration, a business owner should be indifferent between taking a salary or dividends because the same amount of tax will be paid either way. In the case of a salary, it is tax deductible to the corporation reducing its taxable income. It is instead taxed in the hands of the business owner at his or her marginal personal tax rate. In the case of dividends, corporate income tax is paid on the corporately-earned income and the after-tax amount is paid out as a dividend. This dividend is then taxed in the business owner’s hands at the preferred tax rate for dividends, taking into account the “gross-up” and dividend tax

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credit system. Under perfect integration, the total personal income tax paid by a business owner on a salary should be equal to the combined personal and corporate income tax paid where the remuneration is taken in the form of a dividend.

Perfect integration is achieved when the combined federal-provincial personal tax rate is 43.5% and the combined corporate tax rate is 20% (12% federal and 8% provincial). Chart 1 illustrates perfect theoretical integration on \$1,000 of income. As you can see, tax of \$435 is paid on \$1,000 of personally-earned income. This \$435 is exactly equal to the sum of the tax of \$200 paid by a corporation on \$1,000 of corporately-earned income and the tax of \$235 paid at the shareholder level when the \$800 net corporate after-tax income is paid out as a dividend and taxed in the individual shareholder's hands.

**Chart 1: Theoretical Integration of Income Earned Personally vs. Inside a Corporation**

<b>Earned personally by individual</b>	
Personal income	\$ 1,000
Income tax	(435)
<b>Net cash</b>	<b>\$ 565</b>
<b>Earned through a corporation</b>	
Corporate income	\$ 1,000
Small business corporate tax	(200)
<b>Net cash retained after tax</b>	<b>\$ 800</b>
Dividend payable	\$ 800
Net personal tax on dividend	(235)
<b>Net cash to business owner</b>	<b>\$ 565</b>
<b>Conclusion</b>	
Cash - Personal	(565)
Cash - Corporation	\$ 565
<b>Net advantage</b>	<b>\$ -</b>

## **A. SMALL BUSINESS DEDUCTION INCOME**

### **The tax rate advantage (SBD income)**

The reality is, however, that with varying provincial corporate and personal tax rates, perfect integration is rarely achieved. In particular, the actual tax rates in all provinces are quite different than the tax rates upon which the theory of integration is based. The absence of perfect integration means that in most provinces, an absolute tax savings can be realized by having income that is eligible for the small business deduction ("SBD income") taxed inside the corporation at the small business tax rate and then paid out as a dividend, rather than having the corporation pay a tax-deductible salary or bonus to be taxed in the hands of the individual.

The small business deduction is available to Canadian controlled private corporations (CCPCs) that earn active business income subject to the annual small business limit, which is \$500,000 federally and in all provinces other than in Manitoba and Nova Scotia where it is \$400,000.<sup>1</sup>

In nearly all provinces, the combined top marginal personal tax rates are higher than the theoretical "perfect" rate of 43.5% and, in all provinces, the combined federal and provincial small business income tax rate is below the theoretical 20% perfect integration rate (see Chart 2).

<sup>1</sup> Note that for large CCPCs, the federal and provincial (other than Ontario's) small business limit is reduced on a straight-line basis for CCPCs that, in the prior tax year, had taxable capital between \$10 million and \$15 million.

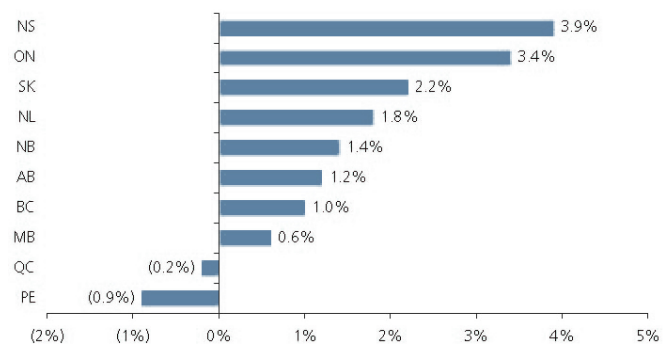
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**Chart 2: Comparative Combined 2011 Federal and Provincial Tax Rates**

	<i>Personal Top Marginal Rates</i>	<i>SBD Income Rates</i>	<i>ABI Rates</i>
<b>Theoretical</b>	43.50%	20.00%	31%
<b>BC</b>	43.70%	13.50%	26.50%
<b>AB</b>	39.00%	14.00%	26.50%
<b>SK</b>	44.00%	14.24%	28.50%
<b>MB</b>	46.40%	11.00%	28.50%
<b>ON</b>	46.41%	15.50%	28.25%
<b>QC</b>	48.22%	19.00%	28.40%
<b>NB</b>	43.30%	16.00%	27.00%
<b>NS</b>	50.00%	15.50%	32.50%
<b>PE</b>	47.37%	12.00%	32.50%
<b>NL</b>	42.30%	15.00%	30.50%

In every province other than Quebec and P.E.I., there is “over-integration.” This means that the sum of the corporate small business tax and the personal tax paid by the shareholder on SBD income earned through a corporation and paid out as dividends is less than the tax otherwise payable if the corporate income was paid out as a salary and taxed at full marginal tax rates personally. As Chart 3 shows, the tax savings in the eight provinces where there is a tax rate advantage ranges from a negligible 0.6% in Manitoba to a high of 3.9% in Nova Scotia.

**Chart 3: Tax Rate (Dis)Advantage of Paying SBD Income as Dividends over Salaries – All Provinces 2011**



**Conclusion 1 – Dividends tax advantage**

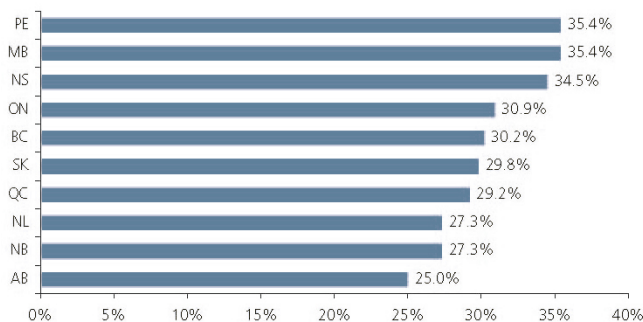
In many cases, in most provinces, dividends may be the preferred method of paying out SBD income in 2011 due to the tax savings stemming from the “tax rate advantage.”

**The tax deferral advantage (SBD income)**

The tax rate advantage discussed above, however, is only part of the story. If the business owner does not need the cash generated by the business currently to meet lifestyle cashflow needs, it may not be necessary to extract funds from the corporation at all. In this case, a generous, potentially long-term tax deferral can be achieved by choosing to have the SBD income taxed in the corporation at the preferential SBD rates as shown in Chart 2 and reinvested inside the company instead of paying that income out as a salary or bonus, to be taxed immediately at a much higher personal tax rate.

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**Chart 4: Tax Deferral Opportunity of Small Business Deduction (SBD) Income Left in the Corporation – All Provinces**



Keep in mind, however, that this is only a tax deferral as the after-tax corporate income will ultimately be taxed in the hands of the shareholder when it is paid out as a dividend. Naturally, the value of this deferral will depend on the length of time the funds can be left in the corporation and the rate of return earned on the funds (see “Value of the deferral advantage” below).

As outlined in Chart 4, this tax deferral ranges from a low of 25% in Alberta to a high of over 35% in P.E.I. and Manitoba.

**Example #1 - Value of the deferral advantage – SBD Income**

So, how much is the tax deferral advantage actually worth? Let’s quantify it through a simple example.

Assume that a corporation in Quebec earns \$100,000 of SBD income in 2011 that is either taxed inside the corporation at the SBD income rate or paid out as a bonus and taxed at the business owner’s top personal marginal rate. If we further assume that the funds are not needed to fund current lifestyle, the remaining after-tax amounts will be invested either within the corporation or personally in a non-registered account, at 5%. For simplicity and to be conservative, we’ll assume the income is in the form of fully taxable

investment income and is taxed annually, rather than deferred as may be the case with equity investments that have the potential to earn (deferred) half-taxable capital gains.

**Chart 5: Comparison of After-tax Values Retained by an Individual for SBD Income in Quebec, Accumulating at 5%, Taxed Annually**

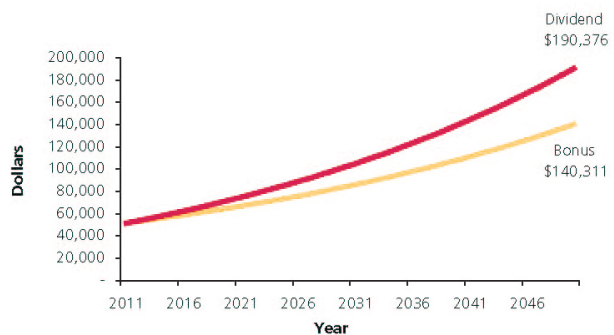


Chart 5 shows the after-tax value of both the dividend and bonus strategy on an annual basis.

The “Bonus” line in Chart 5 shows that a corporation in Quebec that earns \$100,000 SBD income and paid out this amount as a salary or bonus in 2011 to the shareholder would allow the business owner to personally retain \$51,780 after tax in 2011. When this \$51,780 is invested in a non-registered account for 40 years in investments that earn 5%, which is taxed annually, the shareholder could ultimately accumulate \$140,311 aftertax by 2050.

The “Dividend” line in Chart 5 shows that when \$100,000 of SBD income is earned by a corporation in Quebec and the after-tax corporate income is distributed to the shareholder in 2011, the individual would have \$51,557 after paying personal taxes. Note that this is \$223 less than the \$51,780 that would have been available if income were earned directly by the individual, due to the 0.2% tax cost of earning income through a corporation in Quebec in 2011 (see Chart 3). Consequently, there is a slight cost to earning SBD income through a corporation

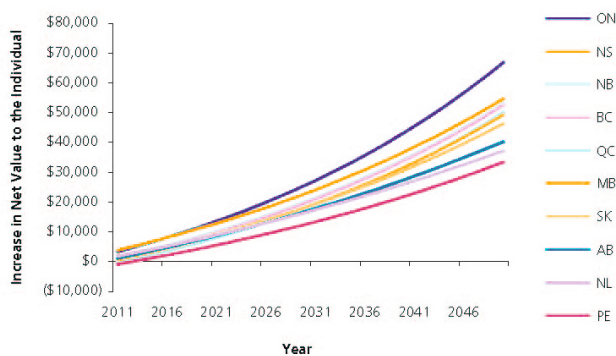
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in Quebec if it is to be distributed immediately to the shareholder as a dividend in 2011. It would therefore be marginally preferable to pay a salary/bonus of \$100,000 to the owner-manager.

If, however, after-tax income is not distributed in 2011 but is left to accumulate within the corporation for, say, 40 years and is then distributed as a dividend, the individual would have \$190,376 in 2050 after payment of all taxes. This is \$50,065 higher than the \$140,311 that would have been available with a salary/bonus payout, due to the reinvestment of the tax-deferred amount within the corporation. This \$50,065 difference represents the savings of incorporating SBD income and leaving it to accumulate over the long term.

Overall, based on this example, we can conclude that if SBD income is earned in Quebec in 2011 and we assume a 5% long term investment return, there is a significant deferral advantage of dividends over a salary/bonus payout after the first year.

**Chart 6: Savings (Cost) when \$100,000 of After Tax SBD Income is Invested in Corporation, at 5%, Taxed Annually and Paid out as a Dividend**



## **BENEFIT OF DIVIDEND STRATEGY – ALL PROVINCES – SBD INCOME**

Chart 6 shows the savings (or cost) of incorporating SBD income in all provinces, assuming a 5% annual return. The break-even point (the year in which savings are achieved by paying a dividend rather than salary/bonus) for SBD income (if invested at 5%) is immediate in all provinces other than Quebec and P.E.I. In other words, immediate savings can be realized from incorporating SBD income and distributing a dividend to the ownermanager in all other provinces. In Quebec, income must be retained until the second year and in P.E.I. until the third year, before paying a dividend if savings are to be realized. Over a 40-year period, savings from paying a dividend out of SBD income range from approximately \$33,000 (P.E.I.) to \$66,000 (Ontario).

### **Conclusion 2 – SBD Income**

From what we have seen above, although dependant on the long term assumed rate of return, it is generally advisable for a CCPC that earns SBD income to have it initially taxed inside the corporation at relatively low corporate tax rates. If not needed to fund current lifestyle, it's then best to retain and invest the SBD income in the corporation and to pay the after-tax amount out as a dividend to the shareholder, so as to enjoy a significant tax deferral of SBD income within the corporation.

## **B. ACTIVE BUSINESS INCOME (Not eligible for the small business deduction)**

Perfect integration is based on a theoretical small business income corporate tax rate of 20%. For income other than SBD income, the actual corporate tax rate is much higher (see Chart 2). To better integrate highly-

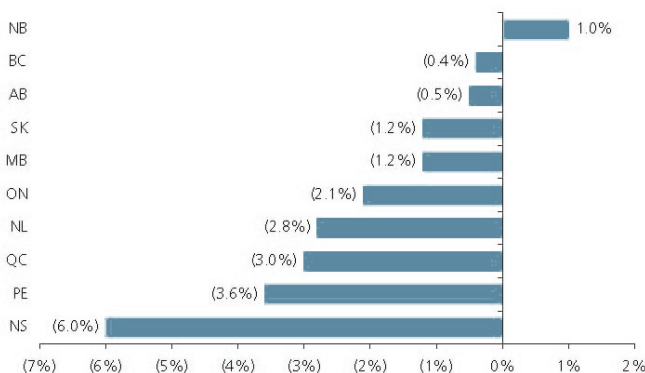
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taxed corporate income, the system of eligible dividends was introduced. The system provides a higher personal gross-up and tax credit for dividends paid from active business income (“ABI”) that is not eligible for the small business deduction, such as ABI in excess of the SBD income threshold.

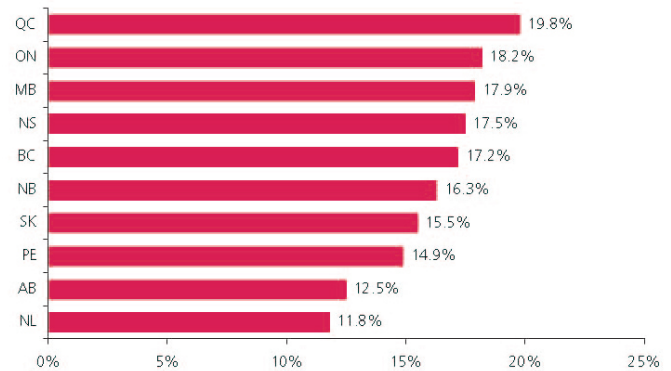
### Tax Cost of Earning ABI

Since corporate and personal tax rates differ among the provinces, each province also has its own rates for the gross-up and tax credit that apply to eligible dividends. Just as with SBD income, perfect integration is rarely achieved for ABI. For 2011, “under-integration” occurs in all provinces other than New Brunswick and there is a tax cost if ABI is paid out as dividends, rather than bonus. As seen in Chart 7, the tax cost in the nine provinces where there is a tax rate disadvantage ranges from 0.4% in British Columbia to 6.0% in Nova Scotia. Although tax savings occur in New Brunswick, the rate is negligible at 1%.

**Chart 7: Tax Rate Savings (Cost) of Paying ABI as Dividends vs. Bonus – All Provinces**



**Chart 8: Tax Deferral Opportunity of ABI Paid as Dividends – All Provinces**



### Tax Deferral Advantage of ABI

There is, however, still a significant tax deferral advantage of leaving ABI not needed to meet current cashflow needs in the company, which is equal to the difference between the highest personal marginal tax rate and the tax rate on corporate ABI. As illustrated in Chart 8, this tax deferral ranges from a low of 11.8% in Newfoundland and Labrador to a high of almost 20% in Quebec.

If funds are not needed by the owner, the tax-deferred amount can be left in the corporation to accumulate, and will eventually earn sufficient income to offset the tax cost that was previously illustrated in Chart 7.

How long will the tax-deferred amount need to accumulate in a corporation to offset the tax cost? Let’s look at an example.

### Example #2 - Value of the deferral advantage – ABI

Let’s assume that in 2011 a corporation in B.C. earns \$100,000 of ABI income that is either taxed inside the corporation at the ABI rate or paid out as a bonus and

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taxed at the business owner's top personal marginal rate. If we further assume that the funds are not needed to fund current lifestyle, the remaining after-tax amounts will be reinvested either within the corporation or personally in a non-registered account, at 5%. For simplicity and to be conservative, we'll assume, as we did in Example #1, the income is in the form of fully taxable investment income and is taxed annually.

If the income were to be paid out in 2011 as a dividend, the owner would have approximately \$400 less than if the income had been paid as a bonus due to the 0.4% tax cost of dividends in British Columbia in 2011 (see Chart 7).

Chart 9 shows the after-tax value of both the dividend and bonus strategies for ABI on an annual basis.

The "Bonus" line in Chart 9 shows that if a B.C. corporation earns \$100,000 of ABI and pays out this amount to the owner as a bonus in 2011, the owner would personally retain \$56,300 after tax in 2011. When this \$56,300 is invested in a non-registered account for 40 years in investments that earn 5%, which is taxed annually, then the owner would have a total of \$166,231 after-tax by 2050.

**Chart 9: Comparison of After-tax Values Retained by an Individual for ABI in B.C., Accumulating at 5%, Taxed Annually**



The "Dividend" line in Chart 9 shows that when \$100,000 of ABI is earned by the corporation and the after-tax corporate income is distributed to the shareholder in 2011, the individual would have \$55,926 after paying personal taxes. This is \$374 less than the \$56,300 that would have been available if income were paid as bonus in 2011, due to the 0.4% tax cost of earning ABI through a corporation in British Columbia (see Chart 7). Consequently, it is slightly more advantageous to distribute ABI as a bonus, rather than dividends, if funds are to be distributed immediately to the shareholder in 2011.

On the other hand, if the after-tax income is not distributed in 2011 but is left to accumulate within the corporation for 40 years at 5% and is then distributed as a dividend, the individual would have \$191,415 by 2050 after payment of all taxes. This is \$25,184 higher than the \$166,231 that would have been available by paying a salary/bonus because of the reinvestment of the taxdeferred amount within the corporation.

If you study Chart 9 carefully, you will notice that in B.C., there is an initial cost of \$374 if incorporated ABI is distributed in the year that it is earned. But provided the income is distributed after the fifth year, savings are still achieved because the benefits of investing the tax deferral, assuming a 5% rate of return, outweigh the initial tax cost of ABI income. While it may first appear that the cost of \$374 is relatively small and therefore the breakeven point should come a lot sooner, the fact is that the tax rate on eligible dividends will be increasing for 2012 and later years in B.C. (and most other provinces), increasing the tax cost for distributing ABI income in those years.

It can therefore be concluded, based on the assumptions above, that if ABI is earned in B.C. in 2011, the income should be distributed as a dividend only if income is to be retained in the corporation for more than 5 years prior to payment of the dividend; otherwise, it is preferable to pay out ABI as a bonus in 2011.

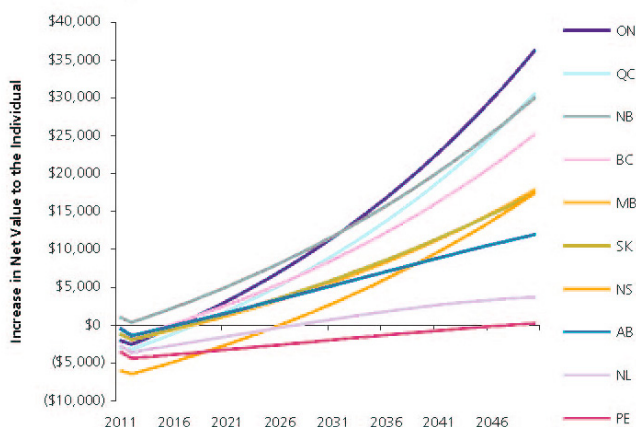
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## SAVINGS (COST) OF DIVIDEND STRATEGY IN ALL PROVINCES - ABI

Chart 10 shows the savings (or cost) of incorporating ABI in all provinces.

From Chart 10 we can see that immediate savings can only be realized in New Brunswick when ABI is distributed in 2011 in the form of a dividend to the owner-manager. In all other provinces it will be preferable to pay salary/bonus in 2011 unless after-tax ABI is retained in the corporation. The amount of time that income must be retained in order to generate overall savings varies by province and is denoted in Chart 11. The shortest retention period is in B.C., where income must be held for 6 years within the corporation, while the longest period is in P.E.I., where income must be retained for 38 years! If income is to be distributed prior to those times, it may be better to pay a bonus from ABI in 2011, rather than paying a dividend in a later year.

**Chart 10: Savings (Cost) when \$100,000 of ABI, invested at 5%, is paid as Dividend - All Provinces**



**Chart 11: Number of years ABI must be retained in a corporation for savings – All provinces (Invested at 5%, taxed annually)**

Province	Number of years
NB	0
BC	6
AB	7
ON	7
MB	8
QC	8
SK	8
NS	16
NL	18
PE	38

### Conclusion 3 – ABI (Not eligible for SBD)

From what we have seen above, although dependant on the long term assumed rate of return, it may be advisable in most provinces for a CCPC that earns ABI to have it initially taxed inside the corporation at a slightly higher corporate tax rate and, if not needed to fund current lifestyle, to retain and invest the ABI in the corporation and then to pay the after-tax amount out as a dividend to the shareholder, so as to enjoy a valuable tax deferral of ABI within the corporation.

## OTHER ISSUES

### No bonus, No RRSP?

As discussed in a paper released last year, *Rethinking RRSPs for Business Owners: Why taking a salary may not always make sense* by Jamie Golombek, one of the problems with paying yourself only with dividends is that you may not be able to contribute the maximum amount to an RRSP. That's because the ability to contribute to an RRSP is dependent on receiving "earned income" in the prior year. Earned income includes salaries and bonuses but does not include dividends.

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A business owner with no other source of earned income needs to consider whether he or she would still be better off with a dividends-only strategy, rather than paying out enough salary/bonus to maximize his or her RRSP contribution. Last year's paper ("Rethinking RRSPs") concluded that the benefits of the deferral advantage associated with SBD income can outweigh the tax-free investment returns inside a registered plan, but this conclusion may not hold true when it comes to ABI. In other words, it may make sense to pay up to \$127,611 of salary/bonus in 2011 when income is over the SBD limit to permit the business owner to make an RRSP contribution for 2011.<sup>2</sup> If this is the case, the decision to leave funds in the company to enjoy the tax deferral associated with ABI would apply to income above the amount needed to maximize the business owner's RRSP contribution.

### **Loss of \$750,000 Lifetime Capital Gains Exemption**

We have seen that tax deferral will often make it advantageous to reinvest after-tax SBD income and, potentially ABI within a corporation; however, accumulating investments in the corporation may hinder a small business owner's ability to claim the \$750,000 lifetime capital gains exemption (LCGE).

The LCGE is available upon disposition of qualified small business corporation (QSBC) shares (or ultimately, upon a deemed disposition at death). To be eligible for the LCGE, "all or substantially all" (interpreted to mean 90% or more) of the value of a small business corporation's assets must be used in an active business or consist of debt or shares of other small business corporations at the date of sale (or death). In addition more than 50% of the corporation's assets must have been used in an active business during the two years prior to disposition of the shares (or death). Investing surplus cash in the

corporation may jeopardize its QSBC status because of the accumulation of investments that do not meet the asset tests outlined above.

If accumulated investments make a corporation ineligible for the LCGE, it may be possible to restore a corporation's QSBC status by extracting non-active assets through a process known as "purification". There are a number of ways to "purify" the company - some of them are simple, while others are more complex. Simple strategies can include: distributing cash or investments in contemplation of sale of a corporation, paying down debts with non-active assets, purchasing additional active business assets or prepaying business expenses, or paying a retiring allowance. More complex strategies often involve paying tax-free inter-corporate dividends from the operating company (the active business) to a connected company or transferring non-active assets or assets with accrued gains to a sister company on a taxfree basis, thus purifying the operating company.

### **Asset protection**

Another issue with respect to accumulating investments inside a corporation is that they are exposed to liabilities of the corporation. As a result, it may be desirable to hold investments in a holding company or sister company, as contemplated in a purification strategy discussed above, rather than in an operating company. In cases where payment of salary/bonus is more advantageous than paying dividends, an RRSP contribution may be a preferred strategy. The federal bankruptcy laws were amended a number of years ago such that RRSP contributions are protected from the owner's (annuitant's) creditors upon bankruptcy, other than contributions made within the final 12 months prior to bankruptcy.

<sup>2</sup>  $\$127,611 \times 18\% = \$22,970$  which is the maximum RRSP contribution limit for 2012, based on 2011 earned income. To definitively answer this question, more complex modeling, involving long term assumptions about rates of return, asset allocation, time horizon and marginal effective personal tax rates at the time of contribution and withdrawal, would need to be done which was beyond the scope of this report.

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