

Tax Planning for Small and Medium Sized Businesses

Tax planning for small and medium sized Canadian corporations requires decisions to be made regarding how consideration is paid to its shareholders. Corporations can distribute cash or assets to its shareholders in two ways: as salary/bonus or via a dividend. The basic difference between salary and dividends is that salaries are paid out of pre-tax profits (i.e. they are a tax deduction to the company) and therefore are only taxed at the shareholder level as salary. Dividends are paid out of after tax profits (i.e. the company does not receive a tax deduction), therefore, the company pays corporate tax on these profits and then they are taxable to the shareholder when they are distributed as dividends. A critical component of the Canadian tax system is the concept of Integration. The corporate tax system for private corporations is intended to integrate with the personal tax system such that income earned in a corporation and distributed out to the shareholder(s) will be taxed on a combined basis at approximately the same rate as it would have been taxed had the shareholder earned the income personally. The mechanisms used to accomplish this goal are the small business deduction (SBD), the refundable dividend tax on hand (RDTOH) account and the capital dividend account (CDA).

Given the inherent complexity within the Canadian tax system it is often difficult for business owners to determine the optimum mix of salary and dividends to minimize their tax liability. This is an area where the advice of a professional accountant can directly contribute to the profitability of their clients. Business owners should always be wary of “rules of thumb” when dealing with the subject of tax planning. The reason why is because no two situations are identical. A good example to illustrate this point is the situation where a company has used up all of their small business deduction and they still have \$100,000 in corporate income which needs to be recognized. The question is: Should the business owner recognize this as a salary or as a dividend from the corporation? A common misconception among financial advisors, business owners, and professionals is that you pay less tax when you receive a dividend as compared to a salary, which of course is not always the case!

The example below demonstrates a situation where it is advantageous for the owner of a Canadian controlled private corporation (CCPC) who has used up the small business deduction to recognize the remaining \$100,000 of corporate income as salary.

(No Small Business Deduction available)	Dividend	(No Small Business Deduction available)	Salary
Corporate income	\$100,000	Corporate Income	\$100,000
Corporate tax (34%)	-\$34,000	Salary Paid to Shareholder	-\$100,000
Net after tax cash available for dividend	<u>\$66,000</u>	Net after tax cash available for dividend	<u>\$0</u>
Dividend to Shareholder	\$66,000	Salary to Shareholder	\$100,000
Personal tax on Dividend (31%)	-\$20,460	Tax on Salary (35% average rate) **	-\$35,000
Net after tax cash to shareholder	<u>\$45,540</u>	Net after tax cash to shareholder	<u>\$65,000</u>
Tax rate	<u>54%</u>	Tax Rate	<u>35%</u>
		Tax savings (cost of dividends vs salary)	19%

** A common income tax misconception is that the marginal tax rate (tax rate on the last dollar of salary earned) is the rate used for each dollar of salary earned. A more appropriate measure for tax planning purposes is the average rate (sum of total tax payable divided by total salary) which can be applied to the total salary to arrive at a more accurate figure of actual tax payable.

In the example above the business owner/shareholder will realize a 19% tax savings by taking a salary instead of dividends. There is a timing difference with respect to when the tax payment is required however there is still a huge tax savings to recognize the corporate income as salary as opposed to a dividend.

The important point to remember from this article is that tax planning is complicated and relying on “rules of thumb” can be a costly mistake. For further advice please contact the tax professionals at CC&C Professional Corporation.

John T Corfield CA CPA (Illinois)

CC&C Professional Corporation

Chartered Accountant

3650 Portage Road

Niagara Falls, Ontario

L2J 2K7

tel 905-371-2300 ext.2223 fax 905-371-2344

www.cccpc.ca

