Should you take a salary or dividend?

Last month I gave you a visual image to explain how an individual and corporation are separate legal entities. I always start by drawing two circles on my notepad: in one circle I write the person's name, and in the other I write "corp."

These circles illustrate the need to keep your business and personal finances separate. Think of all the business income going into the corporation's circle. When you need money for yourself, it then can move into your personal circle for you to spend.

It sounds simple, but determining the type of income to draw (and how it should show up on your books) is one of the biggest decisions an incorporated owner/operator will make.

Salary or dividends?

There are two main ways to draw

money out of a corporation for personal use: salary and dividends. Both have advantages and disadvantages, so let's take a closer look at each one.

When the corporation pays you a salary (or a wage) for the work you do, it can deduct it as an expense and reduce the amount of income it's taxed on. So if the corporation earns $50,000 a year, and you take a salary of $50,000, the corporation's net income is zero. Having shifted that $50,000 into your personal circle, you're obligated to report this amount on your personal income tax return.

There are many good reasons to draw a salary or a wage. It will increase your RRSP contribution room (assuming you're under 71) and you'll be paying into the Canada Pension Plan (CPP). Plus, you'll be able to take advantage of other personal tax credits you may have, such as medical expenses, donations, child-care tax credits, etc.

On the other hand, a salary or wage is considered "employment income" by CRA and is subject to personal income tax rates. You'll be taxed on the full amount of whatever money you draw from the corporation. In addition to the added tax, taking a salary from the corporation requires you to open a payroll account with CRA, make monthly remittances, and prepare a T4 slip each year. While drawing a salary may be advantageous to you, personally, it also means more paperwork for your corporation.

You can also take compensation in the form of a dividend. A dividend is considered "investment income" by CRA, not employment income like a salary or wage. The corporation does not get to deduct dividends from its income. So if the corporation earns $50,000 and you take out a dividend of $50,000, it will still have to pay corporate tax on the full $50,000. To compensate for this, CRA taxes dividends at a much lower rate on your personal tax return.

By taking only a dividend as compensation, you won't be paying into CPP, you won't be able to increase your RRSP contribution room, and you won't be able to deduct certain personal tax credits on your personal tax return.

In terms of accounting or paperwork, taking a dividend from the corporation is simpler than taking a salary as you'll only have to record it in the corporate minutes book and file a T5 slip each year. You're not required to open a payroll account or make monthly source remittances.

Think strategically

Of course, you don't have to choose one type of income over the other. A combination of salary and dividends may be best. How do you know what mix of salary and dividends is right for you? Naturally, there is no "right" mix that will work for everyone, as each person's tax situation is unique. However, everyone can think strategically about compensation.

For example, wages are paid for work done. Whether you do a job, or hire your spouse or kids to do it, you can pay a wage to any or all of them for their efforts. By splitting wage income among several workers in your family, you may be able to reduce the collective tax obligation of your household.

Dividends, meanwhile, are paid to company shareholders. This type of compensation has nothing to do with work, it's a return on an investment. Does your spouse own shares? Do your kids? Again, you can use dividends as part of a tax-planning strategy.

Should you put your family to work and pay them a wage? Should they own shares? Those are great questions to talk to your accountant about. If you're income-splitting, your corporation will have certain legal obligations as an employer, and you'll have to decide whether you're cut out to be the boss of your spouse and kids. If your spouse and kids have shares, it's important to remember that a corporation is controlled by its shareholders. They'll have a say in who should run the business. That's when I get out another sheet of paper and draw a circle that says "family." And that, buddy, is a whole other conversation. ☐

– Scott Taylor is vice-president of TFS Group, providing accounting, bookkeeping, tax return preparation, and other business services for owner/operators. Learn more at www.tfsgroup.com or call 800-461-5970.