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

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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 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 some cases, dividends may be the preferred method of remuneration for incorporated small business owners in 2015, particularly those who do not need funds currently for personal use.

Before year end, small business owners 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 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 cash flow requirements.

In this report, we will examine the theory of integration, taking a close look at the salary / bonus vs. dividends decision in theory and in practice, with a focus on 2015 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.

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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, the corporation can claim a deduction to reduce its taxable income. Instead, the salary is 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 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.

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

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

A. INCOME ELIGIBLE FOR THE SMALL BUSINESS DEDUCTION (SBD INCOME)

The tax rate (dis)advantage

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 different than the tax rates upon which the theory of integration is based. The absence of perfect integration means that in most provinces in 2015, nominal tax savings can be realized by having the corporation pay a tax-deductible salary or bonus to be taxed in the hands of the individual, rather than 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.

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 in 2015 is $500,000 federally and in all provinces other than in Manitoba, where it is $425,000, and Nova Scotia, where it is $350,000.[1]

Chart 2
Comparative Combined 2015 Federal and Provincial Tax Rates

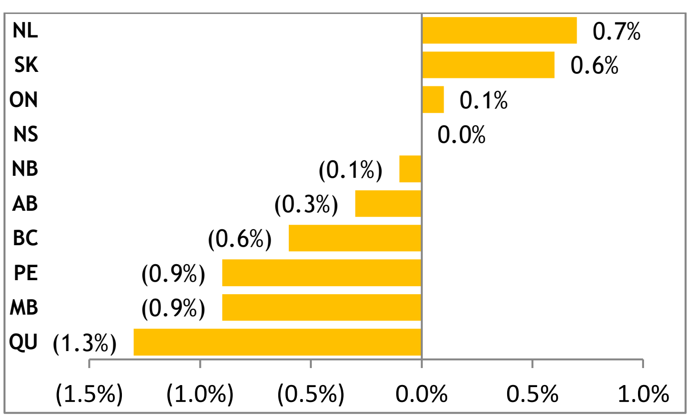
	Personal Top Marginal Rates	SBD Income Rates	ABI Rates
Theoretical	43.50%	20.00%	31.00%
BC	45.80%	13.50%	26.00%
AB	40.25%	14.00%	26.00%
SK	44.00%	13.00%	27.00%
MB	46.40%	11.00%	27.00%
ON	49.53%	15.50%	26.50%
QC	49.97%	19.00%	26.90%
NB	54.75%	15.00%	27.00%
NS	50.00%	14.00%	31.00%
PE	47.37%	15.50%	31.00%
NL	43.30%	14.00%	29.00%

Chart 2 shows that, 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.

In Newfoundland and Labrador, Ontario, and Saskatchewan, there is slight "over-integration" of SBD Income in 2015. 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. Chart 3 shows the tax rate advantage in these three provinces ranges from 0.1% to 0.7%; therefore, if funds are needed in 2015, it would be nominally better to pay dividends, rather than salary / bonus.

In the remaining seven provinces, Chart 3 shows that there is a tax rate disadvantage ranging from less than 0.05% in Nova Scotia to 1.3% in Quebec. Consequently, if funds are needed in 2015 in these provinces, it would be nominally better to pay salary/bonus, rather than dividends.

Chart 3
Tax Rate (Dis)Advantage of Paying SBD Income as Dividends over Salaries - All Provinces 2015



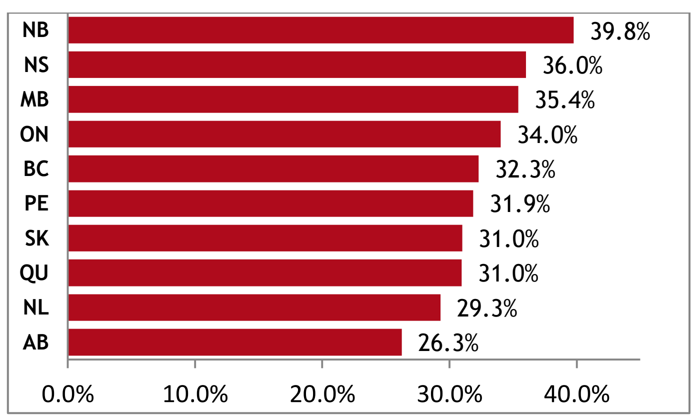
Conclusion 1 - Dividends tax rate (dis)advantage

For 2015, if income is distributed to the shareholder in the year it is earned, dividends may be the preferred method of paying out SBD Income in Newfoundland and Labrador, Ontario and Saskatchewan due to the tax savings stemming from the "tax rate advantage." In the remaining seven provinces, paying salary may be preferred due to the "tax rate disadvantage".

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 cash flow 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.

Chart 4
Tax Deferral Advantage of SBD Income Left in the Corporation - All Provinces 2015



Keep in mind, however, that this is only a tax deferral and the after-tax corporate income will ultimately be taxed in the hands of the shareholder when it is paid out as a dividend.[2] 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 "Benefit of a Dividend Strategy" below).

As outlined in Chart 4, the tax deferral ranges from a low of about 26% in Alberta to a high of almost 40% in New Brunswick.

Assume that a corporation in Quebec earns $100,000 of SBD Income in 2015 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 a 5% rate of return. 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.

A corporation in Quebec that earned $100,000 SBD Income and paid out this amount as a salary or bonus in 2015 to the shareholder would allow the business owner to personally retain about $50,000 after tax in 2015.

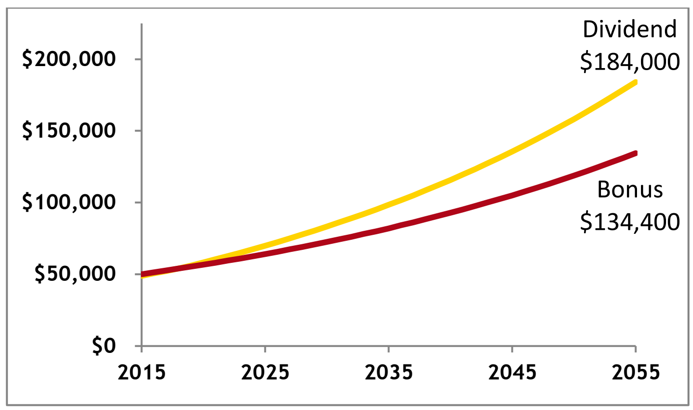
When $100,000 of SBD Income is earned by a corporation in Quebec and the after-tax corporate income is distributed to the shareholder as a dividend in 2015, the individual would have about $48,700 after paying personal taxes. Note that this is $1,300 less than the $50,000 that would have been available if income were earned directly by the individual, due to the 1.3% tax cost of earning income through a corporation in Quebec in 2015 (see Chart 3).

Consequently, there is a slight cost to earning SBD Income through a corporation in Quebec if it is to be distributed immediately to the shareholder as a dividend in 2015. It would, therefore, be marginally preferable to pay a salary/bonus of $100,000 to the owner-manager.

Suppose, however, that after-tax income is not distributed in 2015 but is left to accumulate within the corporation for up to 40 years and is then distributed as a dividend. 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 when $50,000 is invested in a non-registered account for 40 years in investments that earn 5%, which is taxed annually, the shareholder could ultimately accumulate about $134,400 after-tax in 40 years, by 2055.

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



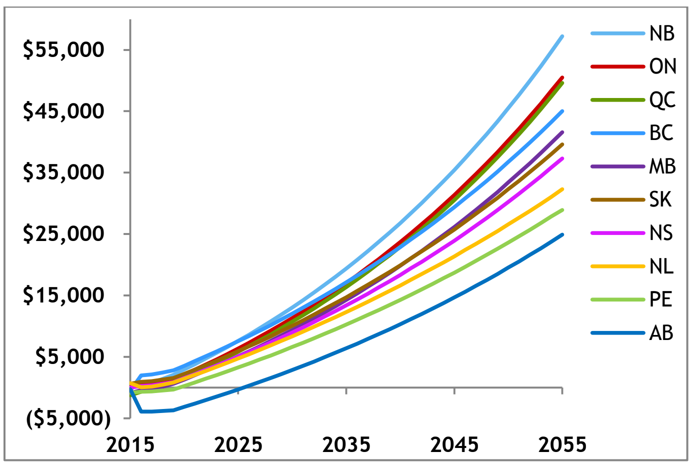
The "Dividend" line in Chart 5 shows the amount that would be available if after-tax SBD income was invested in a corporation, and corporate funds were distributed to the shareholder in a later year. The individual would have about $184,000 in 2055 after payment of all taxes. This is $49,600 higher than the $134,400 that would have been available with a salary / bonus payout, due to the reinvestment of the tax-deferred amount within the corporation. This $49,600 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 2015 and we assume a 5% long term investment return, there would be a significant deferral advantage of paying dividends over a salary/bonus payout over a 40-year period.

Benefit of a Dividend Strategy – All Provinces – SBD Income

Chart 6 shows the savings (or cost) over time of incorporating SBD Income in all provinces, assuming a 5% annual return.

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



Over a 40-year period, savings from paying a dividend out of SBD Income range from approximately $24,900 (in Alberta) to $57,200 (in New Brunswick).

Immediate savings can be realized from incorporating SBD Income and distributing a dividend to the owner-manager in Newfoundland, Ontario and Saskatchewan, due to the tax rate advantage outlined in Chart 3.

In other provinces, which have a tax rate disadvantage (as shown in Chart 3), income must be retained within the corporation for a number of years before paying a dividend if savings are to be realized. Chart 7 shows the breakeven point for each province.

Chart 7
Number of years SBD Income must be retained in a corporation for savings – All provinces (Invested at 5%, taxed annually)

Province	Number of years
NL	0
ON	0
SK	0
BC	1
NB	1
NS	1
MB	3
QC	3
PE	5
AB	11

In the seven provinces where there is a tax rate disadvantage on SBD Income (see Chart 3), income must be retained for a period ranging from 1 year (in British Columbia, New Brunswick or Nova Scotia) to 11 years (in Alberta) before paying a dividend for savings to be realized. Income should be distributed as a dividend only if income is expected to be retained in the corporation until the breakeven point prior to payment of the dividend; otherwise, it is preferable to pay out SBD Income in 2015.

Conclusion 2 – SBD Income

Although dependent on the long term assumed rate of return and time horizon, if funds are not needed to fund current lifestyle, it may be advisable to have SBD Income initially taxed inside the corporation at relatively low corporate tax rates. The after-tax SBD Income can then be retained and invested in the corporation with the after-tax amount later paid 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)

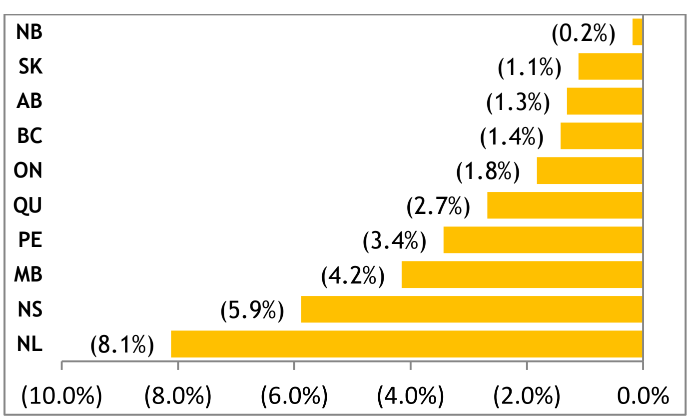
Perfect integration is based on a theoretical small business income corporate tax rate of 20%. For income other than SBD Income, the actual corporate tax rate is much higher (see Chart 2). To better integrate highly-taxed corporate income, the system of eligible dividends was introduced. The system provides 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. As a result, the personal tax rate for eligible dividends is lower than for non-eligible dividends.

Tax Cost of Earning ABI

Since corporate and personal tax rates differ among the provinces, each province also has its own rates for calculating the tax credit that applies to eligible dividends. Just as with SBD Income, perfect integration is rarely achieved for ABI.

For 2015, "under-integration" occurs in allprovinces and there is a tax cost if ABI is paid out as dividends, rather than bonus. As seen in Chart 8, the tax cost (tax rate disadvantage) ranges from 0.2% in New Brunswick to 8.1% in Newfoundland and Labrador.

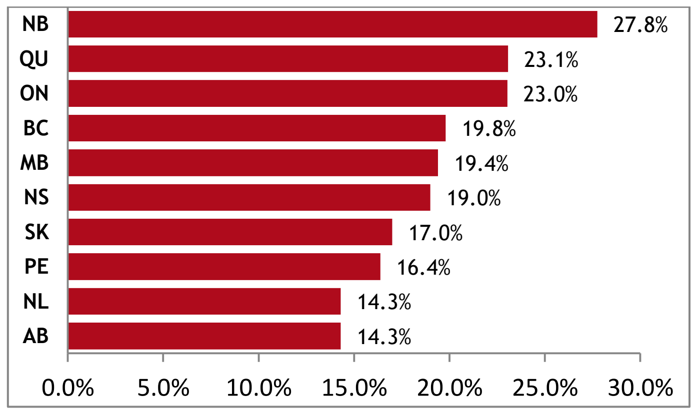
Chart 8
Tax Rate Disadvantage (Cost) of Paying ABI as Dividends vs. Bonus - All Provinces



There is, however, still a significant tax deferral advantage of leaving ABI not needed to meet current cash flow 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 9, this tax deferral ranges from a low of about 14% in Alberta to a high of almost 28% in New Brunswick.

Chart 9
Tax Deferral Advantage of ABI Paid as Dividends - All Provinces



If funds are not needed by the owner, the tax-deferred amount can be left in the corporation to accumulate, and may eventually earn sufficient income to offset the tax cost that was previously illustrated in Chart 8.

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 2015 a corporation in B.C. earns $100,000 of ABI that is either taxed inside the corporation at the ABI 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 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.

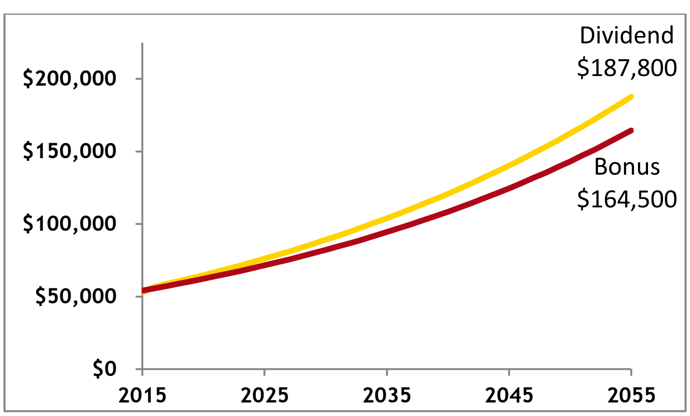
If the corporation paid out $100,000 of ABI to the owner as a bonus in 2015, the owner would personally retain about $54,200 after tax in 2015.

If the corporation distributed $100,000 of ABI to the shareholder as a dividend in 2015, the individual would have about $52,800 after paying personal taxes. This is about $1,400 less than the $54,200 that would have been available if income were paid as bonus in 2015, due to the 1.4% tax cost of earning ABI through a corporation in British Columbia (see Chart 8).

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 2015.

Suppose, however, that after-tax ABI does not need to be distributed in 2015 and is left to accumulate within the corporation for up to 40 years and is then distributed as a dividend. Chart 10 shows the after-tax value of both the dividend and bonus strategies for ABI on an annual basis.

Chart 10
Comparison of After-tax Values Retained by an Individual for ABI in B.C., Accumulating at 5%, Taxed Annually



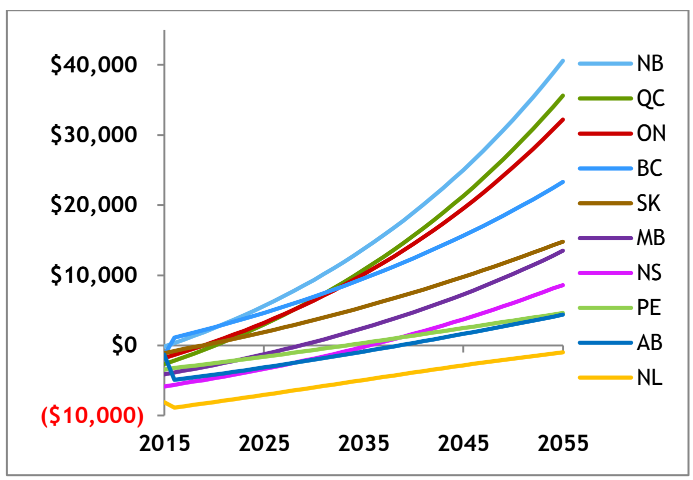
The "Bonus" line in Chart 10 shows that when $54,200 is invested in a non-registered account for 40 years in investments that earn 5%, which is taxed annually, then the owner would have a total of about $164,500 after-tax in 40 years, by 2055.

The "Dividend" line in Chart 10 shows that if the after-tax ABI is not distributed in 2015 but is left to accumulate within the corporation for 40 years at 5% and is then distributed as a dividend, the individual would have about $187,800 by 2055 after payment of all taxes. This is about $23,300 higher than the $164,500 that would have been available by paying a salary / bonus because of the reinvestment of the tax-deferred amount within the corporation.

Benefit of a Dividend Strategy - All Provinces - ABI

Chart 11 shows the savings (or cost) over time of incorporating ABI in all provinces, assuming a 5% annual return.

Chart 11
Savings (Cost) when $100,000 of ABI, invested at 5%, is paid as Dividend - All Provinces



In Newfoundland and Labrador, there is a cost of $1,000 for retaining ABI in the corporation, investing corporate funds at 5% interest, and paying it out after 40 years. In all the other provinces, the savings from this deferred dividend strategy for ABI ranges from approximately $4,400 (in Alberta) to $40,600 (in New Brunswick).

Due to the tax rate disadvantage on ABI that exists in all the provinces in 2015 (as shown in Chart 8), the tax savings are not immediate. Income must be retained within the corporation for a number of years before paying a dividend if savings are to be realized.

The amount of time that income must be retained in order to generate overall savings (the breakeven point) varies by province and is denoted in Chart 12.

Chart 12
Number of years ABI must be retained in a corporation for savings – All provinces (Invested at 5%, taxed annually)

Province	Number of years
BC	1
NB	1
ON	4
SK	4
QC	6
MB	14
PE	19
NS	21
AB	24
NL	>40

The shortest retention period is in B.C. and New Brunswick, where income must be held for one year within the corporation before savings can be realized by paying deferred dividends. The longest period is in Newfoundland and Labrador, where income must be retained for more than 40 years.

If it is anticipated that income will be distributed prior the breakeven point, it may be better to pay a bonus from ABI in 2015, rather than paying a dividend in a later year.

If it is anticipated that income will be distributed after the breakeven point, paying deferred dividends may result in savings.

Conclusion 3 – ABI (Not eligible for SBD)

Although dependent on the long term assumed rate of return and time horizon, if funds are not needed to fund current lifestyle, it may be advisable for a CCPC to have ABI initially taxed inside the corporation at relatively low corporate tax rates. The after-tax ABI can then be retained and invested in the corporation with the after-tax amount later paid 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 previous report, Rethinking RRSPs for Business Owners: Why taking a salary may not always make sense, one of the problems with paying only dividends is that the business owner 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.

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. The report Rethinking RRSPs for Business Owners concluded that the benefits of the deferral advantage associated with SBD Income may 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 $140,944 of salary / bonus in 2015 when income is over the SBD limit to permit the business owner to make an RRSP contribution for 2015.[3] 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.

Tax Free Savings Account (TFSA)

The analysis in this report assumes that personal investments will be held in non-registered accounts, in which income is taxable. Holding personal investments in a TFSA allows investment income to be earned tax-free, so a greater amount may be accumulated in the business owner's hands. This may impact the decision to invest personally versus through a corporation.

Our report, *TFSAs for Business Owners… A Smart Choice*,[4] provides an in depth analysis for business owners who are considering investing in a TFSA, rather than in a corporation.

Loss of 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 lifetime capital gains exemption (LCGE), which is $813,600 in 2015.[5]

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, 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[6] or transferring non-active assets or assets with accrued gains to a sister company on a tax-free 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.

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1 Note that for large CCPCs, the federal and provincial 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.

2 Starting in 2016, there will be an increase in the effective tax rate on non-eligible dividends. The gross-up factor for non-eligible dividends (which determines the taxable amount included in income) will decrease, and there will be a gradual decrease in the dividend tax credit for non-eligible dividends. The combined effect of this measure is as follows:

Small Business Tax Rate Reduction and DTC Adjustment for Non-Eligible Dividends

	2015	2016	2017	2018	As of 2019
Small business tax rate (%)	11	10.5	10	9.5	9
Gross-up (%)	18	17.0	17	16.0	15
DTC (%)	11	10.5	10	9.5	9
Top federal rate on non-eligible dividends	21.22%	21.62%	22.21%	22.61%	22.97%

3 $140,944 X 18% = $25,370 which is the maximum RRSP contribution limit for 2016, based on 2015 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.

4 The report *TFSAs for Business Owners… A Smart Choice* is available online at https://www.cibc.com/ca/pdf/small-business/tfsas-for-business-owners-en.pdf.

5 The Lifetime Capital Gains Exemption (LCGE) is $1 million for dispositions of qualified farm or fishing property after April 20, 2015. Qualified farm or fishing property includes shares of a Canadian-controlled private corporation if more than 50% of the fair market value of the property owned by the corporation was attributable to property used principally in a farming or fishing business carried on in in Canada.

6 Changes were proposed in the 2015 Federal Budget that may result in capital gains treatment for certain inter-corporate dividends. You should consult a tax advisor prior to making inter-corporate dividend payments.

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Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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