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TAX MATTERS

Year-end tax strategies for business owners

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The end of the year is fast approaching, and if you own an incorporated business with a Dec. 31 year end, you may have a decision to make about what to do with excess profits in your company.

What are your options? There are a few, but the basic options are these: No. 1, You can leave those dollars in the corporation and not pay additional amounts to yourself this year, No. 2, you can pay yourself additional salary or bonuses with those dollars, or No. 3, you can pay yourself dividends from your corporation. Which is best? Not surprisingly, the answer depends on a few factors. Let's take a closer look.

The math
There's a common-sense approach when it comes to excess profits in a corporation earning active business income (ABI): If you don't need the cash to meet your costs of living, and you care most about paying the least amount of tax today, then leaving your profits in your corporation and not paying yourself additional salary, bonuses or dividends will generally accomplish that.

You see, your corporation will face tax at low rates on the first $500,000 of its ABI (the Canada-wide average is about 14 per cent, but varies by province). On ABI over $500,000, the rate increases but is still pretty reasonable (an average of 28 per cent for most corporations, but it varies by province). These rates are generally lower than what you'd pay in personal taxes on that same income. Once you pay the excess profits out of your company to yourself as salary or dividends, you'll pay tax personally, and the total tax bill – your company's taxes and your personal taxes combined – becomes higher.

So, by leaving the profits in the company, you'll generally defer some tax. The taxes deferred are pretty meaningful, at an average of about 36.5 per cent if your total ABI is $500,000 or less. In dollar terms, you'll defer taxes of about $3,650 on $10,000 of ABI in this situation (varies by province). Not too shabby. On ABI over $500,000, the deferral averages about 22 per cent.

But what if you need the cash? Then you have a decision to make. Should you pay salary (or a bonus), or dividends? Our tax system is designed so that, in theory, you shouldn't care which it is. The total tax paid by you and the company combined should be about the same whether you choose salary or dividends. And, for the most part, tax rates do work this way. On $10,000 of ABI in your company, you'll save an average of about $10 in taxes by choosing either salary or dividends, depending on which province or territory you live in (in most provinces you'll gain a few bucks by paying salary in 2016 – but speak to a tax pro if you want to know the exact figures). The truth is, there are other factors which are likely more important to consider.

The factors
If you take additional salary, this will create registered retirement savings plan (RRSP) contribution room (salary of $144,500 in 2016 will provide the maximum in RRSP contribution room of $26,010 for 2017). In addition, salary gives rise to Canada Pension Plan (CPP) contributions ($54,900 in salary provides the maximum in CPP benefits in 2016). So, if you're behind in saving for retirement, consider salaries as a means to bolstering your retirement savings and pension income. You might also choose to pay salaries to a lower-income spouse if that will enable him or her to claim child care expenses

(which must be claimed by the lower income spouse; $12,000 or more of salary will enable tax savings from eligible child-care expenses).

Dividends, on the other hand, will allow you to avoid CPP contributions, which can allow you to invest those savings on your own. If your retirement income is already assured, or you're disciplined enough to invest the amount you'd otherwise contribute to the CPP, then dividends could make sense. Dividends can also make sense if you'll be paying these to a family member who is in a lower tax bracket than you. You might pay these dividends to family members if they directly own shares in your company, or if those shares are held by a family trust and you can distribute dividends to the trust to be taxed in the hands of adult family members. It's possible to pay dividends of up to about $50,000 in most provinces with little or no tax to the recipient if he or she has no other source of income.

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