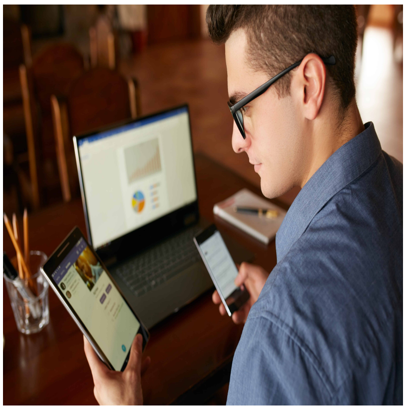

Own a Small Business? Here's How to Pick Between Paying Yourself a Salary vs. Dividends

Description

If you're reading this, congratulations! Chances are that you not only own a business (or are self-employed) but have also made enough money to begin paying yourself.

Unfortunately, doing so isn't as simple as just transferring the cash from your business to personal bank account. If you are incorporated, you have two ways of getting paid: by dividend or salary.

Let's compare the pros and cons of each approach and see which option business owners should choose.

Salary

If you've worked full time before, a salary is familiar. If you pay yourself a salary through your corporation, the payment becomes an expense of the corporation (reducing its taxable income) and is recorded as employment income for you (this means you get a T4).

To pay yourself a salary, your corporation will have to register a payroll account with the CRA. This is because each time you are paid a salary, the corporation needs to withhold and remit deductions in the form of CPP and income tax (provincial & federal) to the Receiver General.

Benefits of a salary include the ability to accrue RRSP contribution room, lower the amount of corporate tax paid, more predictable and steady cash flows, fewer surprise tax bills, and an easier time providing proof of income if you're applying for a large loan or mortgage.

Dividends

A dividend is a payment to a shareholder of a corporation from its after-tax earnings. Unlike a salary, paying a dividend does not count as a corporate expense and thus will not reduce the corporate tax payable. However, when the dividend is paid to you, you owe less tax compared to employment income owing to the dividend tax credit.

Paying a dividend is a lot easier than a salary. All you need to do is declare a dividend to a class of shareholders, and that dividend is split proportionality among them. If you're the sole shareholder, its as easy as declaring a dividend and transferring the cash to your personal account. At the end of the year, you'll need to file a T5 for each shareholder.

Dividends have several advantages, including simplicity (no need to register for payroll and remit source deductions), no need to contribute to CPP, lower personal tax rates, and less chance of payroll penalties. However, you do not get RRSP room, so make sure you have some means of saving for retirement (such as a TFSA).

The Foolish takeaway

It is worth noting that the concept of tax integration makes the amount paid in either scenario roughly equal — it's either your corporation or you personally paying the tax. There's no free lunch here.

So, should small business owners choose dividends or a salary? Like many questions, the answer is, "it depends." Your personal situation will dictate a lot of these choices. The following sample scenarios might help you decide:

1. If you don't want the hassle of setting up payroll and remitting source deductions, paying dividends will be preferable.
2. If you want to contribute to a RRSP and CPP, paying a salary will be preferable.
3. If you will require proof of steady income in the near future to qualify for a mortgage, paying a salary will be preferable.

4. If you already have a salary from another job and want to minimize your personal tax bill, paying dividends will be preferable.

5. If your business income is too sporadic or irregular to pay a salary, paying dividends will be preferable.

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