CESTNICK

TAX MATTERS

Year-end tax planning for business owners is different this year

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I was talking to my son this week about business ideas. We laughed at the business started about five years ago by 22-year-old Mathew Carpenter, who created ShipYourEnemiesGlitter.com where, for as little as US$9.99, the business ships a package that, when opened, scatters glitter all over the place. Mr. Carpenter started the business "as a bit of a joke," but the business took off, and was then sold by him for US$85,000 when he quickly became tired of shipping glitter to people. Nevertheless, his business idea was a clever one.

Business owners all over Canada have been clever with their service and product offerings. Most want to be clever when it comes to their tax planning as well. And so, this time of year, business owners often look at their own planning to reduce taxes, and there's perhaps no issue bigger than whether to pay yourself salary or dividends from your own company. This year, the pandemic should cause a rethinking of this issue. Let me explain.

THE THEORY

If you operate your business through a corporation, there are a few ways to pay yourself cash from your corporation – the two most common being salary or dividends. Our tax law has been designed so that you should be indifferent between earning income directly (that is, if your business is not incorporated), or through a corporation where you then pay yourself salary or dividends. This is called the theory of integration – and it works fairly well when earning active business income.

It's worth mentioning, however, that there can be a nice deferral of tax on active (not passive) business income earned through a corporation. This is to encourage reinvestment in your business. Specifically, your corporation is likely to pay less tax than you would if you earned the income personally, but you'll face personal tax when you eventually pay yourself salary or dividends. The total tax bill (personal and corporate combined) will end up

about the same as if you had earned the income personally.

Many business owners choose to incorporate their businesses thanks to the tax deferral and limited liability offered by a corporation. So, how do you decide each year whether to pay yourself salary or dividends? There are several considerations, some of which have changed owing to COVID-19.

THE CONSIDERATIONS

Retirement income. How will you make ends meet in retirement? If you want to collect Canada Pension Plan benefits, you'll need employment earnings (salary) to participate. Similarly, if you want to set aside money in a registered retirement savings plan, you'll need salary to create RRSP contribution room. Dividends won't help with either CPP benefits or RRSP room.

Timing of income. Some benefits may be reduced as your income increases. A corporation enables you to control the timing and amount of income you report personally. You may want to defer salary or dividends to 2021 in some cases. Some benefits that are affected by your level of income include: the new Canada Recovery Benefit, Old Age Security benefits and the Canada Child Benefit.

Liability for corporate taxes. If your corporation is struggling with cash flow, perhaps because of COVID-19, and has difficulty paying taxes owing, be aware that paying yourself dividends could leave you personally liable for the taxes owed by your company. This is not the case with salary, which is paid to you for services rendered as an employee.

Ability to use losses. If you pay yourself salary, your corporation can deduct the amount as an expense, which won't be helpful if your company has losses this year and for the foreseeable future. So, you'll face tax personally on the salary without offsetting tax relief to the company. Dividends may make more sense in this case.

Employment expenses. Common employee expenses during the pandemic include home office, child care and moving expenses. You'll need to have salary against which to deduct these costs. Dividends won't cut it here.

Government support. Your company's eligibility and level of support under the Canada Emergency Wage Subsidy (CEWS) and Canada Emergency Business Account (CEBA) is dependent on the company's payroll. Salary (which is part of your payroll), but not dividends, could increase the support under these programs.

Mortgages and loans. If your cash flow has become tighter during COVID-19, the need to mortgage, remortgage or borrow money may increase. A consistent level of salary is often important when applying for these loans. Dividends, particularly when they have been sporadic, may not help as much here.

THE APPROACH

Your best approach is likely to pay some salary to yourself (the amount is different for everyone) to allow for claiming certain deductions or credits, and to provide RRSP contribution room and CPP entitlement. Above a certain amount of salary, payment of dividends can make sense.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.