How to Pay Yourself from Your Corporation: Salary Vs. Dividends — Avalon Accounting

We work with business owners from across Canada and we are often asked about the difference between salary and dividends. If you own a business through a corporation, you have the ability to pay yourself a salary or dividends or a combination of both.

This article will look at the difference between salary and dividends and the main advantages and disadvantages of each. We will also see some common scenarios for when a business owner may choose one method over the other.

Type of Transaction

If you are paying yourself a salary or wage (same thing), the payments become an expense of the corporation and then employment income for you personally - you'll get a T4. The expense reduces the corporation's taxable income which reduces corporate taxes owing.

How it's Done

To pay yourself a wage, the corporation will need to register a payroll account with CRA. Each time you are paid, the corporation will need to withhold source deductions (CPP and Income Tax) from your pay. These source deductions are then remitted to the Receiver General (CRA) on a regular basis. In addition, each year the corporation must prepare and file T4s for any employees that earned wages.

We wrote all about registering for a payroll account and remitting source deductions **here**.

Why Choose Salary

Paying yourself a wage can be a way for you to earn a steady and predictable personal income. Some key advantages of using this method include:

- **RRSP Contribution Room** - Paying yourself a wage will allow you to build RRSP contribution room, whereas paying yourself via dividends does not.
- **CPP Contributions** - This is a double edged sword. Wages will allow you to contribute to the Canada Pension Plan (dividends do not). This means you will benefit in the future when you collect CPP, but it also means that the CPP contributions are a cost for you and for the corporation. Less cash now, more cash later.
- **Fewer Surprise Tax Bills** - Income tax is withheld from each payment and remitted to the Receiver General. When you file your personal tax return you will have already paid income tax and will avoid a surprise personal tax bill. When paying dividends, income tax isn't withheld and remitted which often creates personal taxes owing in April.

- **When Applying for a Mortgage** - When you are attempting to qualify for a mortgage, banks like to see steady, predictable income. Earning employment income like this will help show that steady income, whereas dividend income may not be looked at as favorably.

Type of Transaction

Dividends are payments to shareholders of a corporation that are paid from the after tax earnings of the company. This means that dividends are not a corporate expense and do not reduce the corporate taxes paid. The flip side is that dividends carry less personal tax liability than wages because they come with a dividend tax credit (more on tax differences below).

How it's Done

In practice, paying dividends to shareholders of a corporation is fairly easy. Dividends are declared and cash is transferred from the corporate account to a shareholder's personal account in one or many transactions. Each year, the corporation must prepare and file T5s for any shareholders who received dividends.

The tricky thing with dividends is that they are issued and paid based on share ownership. For example, if Pied Piper Ltd. wants to issue $100,000 in dividends to the owners of its Class A common shares, it must do so based on percentage of ownership. So, if Dinesh owns 30% of Pied Piper's class A shares and Richard owns the other 70%, then Dinesh would receive $30,000 and Richard would receive $70,000. This can make it difficult to allocate different amounts of income to multiple shareholders if they all own the same class of shares.

Why Choose Dividends

Paying dividends can be a simple way for business owners to withdraw money from their corporation. Some key advantages include:

- **Lower Cost** - Paying dividends removes the need to contribute to CPP, which reduces corporate and personal costs. The downside is that it does not allow you to contribute to the Canada Pension Plan. More cash now, less cash later.

- **Simplicity** - If you own 100% of your corporation, you can just declare a dividend and transfer cash from the company to your personal account. No need to register for payroll and remit source deductions.

- **Less Chance for Payroll Penalties** - Payroll remittances are relentless. Usually they have to be paid each month and late payments come with **stiff penalties**. Paying dividends eliminates the chance of late or missed payroll remittances. That being said, filing of T5s must be completed on-time once per year when paying dividends.

Which Method Creates Less Tax?

(Spoiler - the answer is "it depends")

Ok, so the most common question we get about salary vs. dividends is "which method allows me to pay less tax?". This is an important question, but **changes to legislation** that took effect at the beginning of 2018 have made it more difficult to reduce taxes by choosing one method or the other.

I've listed this question down here instead of at the top because I think it is more important to first understand and consider the issues listed above before comparing various wage and dividend models for tax savings. Often, the results of calculations show fairly minimal tax savings one way or another, and there is a reason for that.

Integration

There is a tax concept called integration that legislation aims to implement. The idea is that there should be little to no difference in the overall income tax paid (personal tax + corporate tax) when comparing dividend payments and wage payments of the same amount. How this works:

- Wages reduce corporate taxes but create higher personal taxes than dividends.
- Dividends do not reduce corporate taxes, but create less personal taxes than wages.

Dividend Sprinkling

In the past, corporate shareholders could skirt the issue of integration and tip the scales of tax savings in their direction by using a technique called dividend sprinkling. This was accomplished by spreading out dividend payments to a lower income earning spouse or adult family member. Because the spouse or adult family member are in a lower tax bracket than the person operating the business, there would be less personal tax to pay on their dividend income.

Now that it is more difficult to implement dividend sprinkling, it is especially important to consider the qualitative factors discussed earlier when deciding which method of payment to use.

Learn more about the limitations of dividend sprinkling on our article about **Tax on Split Income (TOSI)**.

Calculating and Comparing Taxes

Although there may not be as much in tax savings to be had as in the past, we can still do some simple calculations to help determine whether dividends or wages are more tax efficient.

The idea is to calculate the total taxes (corporate + personal) that would be paid if dividends were used and compare that with the total taxes that would be paid if wages were used. You can use a tool like the **SimpleTax Calculator** to calculate personal tax estimates, and you will also need your **corporate tax rate** to estimate corporate taxes. Or if that sounds like a pain, you can **call up your accountant** and they'll be happy to run some calculations (we love that stuff).

Common Scenarios

Lastly, let's look at a few common scenarios that we see and discuss what you might consider as a business owner in each case.

- **Bad at Administrative Tasks** - If making payments on time is a weakness that you have, then it may be easier and less costly to pay yourself using dividends. Wages require the regular, on-time payment of source deductions. If source deduction payments are missed or late, the penalties can add up quickly.

- **Qualifying for Financing** - If you plan on purchasing a home in the near future and know that you will need to qualify for a mortgage, it may be better to pay yourself as an employee (wages / salary). Banks like to see the steady income more than sporadic dividend payments.

- **Having Children / Parental Leave** - If you plan on having children sometime soon and you would like to earn **Maternity or Parental Benefits**, then it may be better to earn income through wages. This is because withholding and remitting employment insurance premiums can enable the employee to collect maternity or parental benefits.

- **Paying Bonuses** - Sometimes tax can be reduced or deferred by paying wages in the form of a bonus to business owners. This is a bit complicated and isn't applicable in every scenario, but it's important to know that the technique exists.

- **Working Income Tax Benefit -** The **working income tax benefit** is a refundable tax credit intended to provide tax relief for eligible working low-income individuals and families. It may be beneficial to pay yourself a small salary from your business to trigger this tax credit on your personal taxes. Consider this if you have low personal or family net income for the year.

We can Help - There are a lot of moving pieces and things to consider when deciding to pay yourself through wages or dividends. Luckily we like talking about this stuff, so **give us a shout** if you have any questions.

Learn More

Interested in learning more about corporations in Canada?

We've written about **what a holding company is used for in Canada**. We've also posted about the **steps to incorporating your business**.