Compensation for a business owner: a strategic decision

Steve Jobs received a salary of $1 for leading Apple… but he flew in his own private jet and owned stock that had soared in value. If you own a small business, some more “traditional” options are available to you when it comes to your compensation. Here’s an overview.

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It is often said that SMEs are the beating heart of the Canadian economy. As we can see, this statement seems justified in several respects:

Source: Wagepoint, BDC / Graphics: Actualis

So small business owners carry a lot of responsibility. On the other hand, they enjoy more flexibility than employees when it comes to managing their income.

The basic choice: salary or dividend

Because the owner is both a shareholder of the company and its principal employee, entrepreneurs have a choice: pay themselves a salary, a dividend, or both. While a salary provides compensation to the owner as an employee, a dividend is a way of transferring some or all of the company's profits to the owner as a shareholder. In other words, a salary is a return on work and a dividend is a return on capital.

Salary

A salary, which also includes bonuses, allows an entrepreneur to receive a regular income. When just starting out, an entrepreneur will often choose not to take a salary until the company itself has established solid revenues.

At that point, the owner might think about the four major characteristics of a salary.

- Paid regularly, it can provide a stable and predictable personal income stream.
- As such, it can facilitate the approval of loans – like a mortgage, for instance – from financial institutions.
- It constitutes "earned income" and thus opens up RRSP contribution room.
- It involves contributions to the public pension plans, which will provide a basic pension when the entrepreneur retires.

On the other hand, a salary comes with a certain administrative burden, since at-source deductions must be calculated and paid on time. If not, there are stiff penalties.

Dividends

Dividends, which may be paid once or several times a year, also have specific characteristics.

- Many find them easier to administer: an amount can simply be withdrawn when needed.
- No at-source deductions are required.
- However, tax will be payable when the entrepreneur submits a personal income tax return.
- The following year, income tax instalment payments might be required based on these amounts.
- Since dividends are not earned income, they do not give rise to any RRSP contribution room or public pension benefits.

Note that dividends are taxed at a lower rate than wages. Keep in mind, however, that they are paid out of the company's profits, on which the company itself has been taxed. As a rule, the tax concept known as "integration" tends to ensure that, once the "net" amount is in the individual's hands, the same amount of tax has been paid overall.

Another point: partners can pay themselves different salaries based on their respective participation in company operations, but the dividend is based on their participation in the share capital: if they own equal shares, the dividend will be the same for everyone.

The “small business limit”

Another difference is that a salary counts as an operating expense and will thus reduce the company’s profits. This is not the case for a dividend. As it happens, an SME is eligible for a reduction of the usual corporate tax rate if its annual profits are less than $500,000. This small business deduction is commonly called the “small business limit” by accountants. Under certain circumstances, paying a salary could help to keep profits below this threshold. That said, other factors also have to be taken into consideration, including the entrepreneur’s personal tax situation.

Other options

An entrepreneur may also, under certain circumstances, take an amount out of the company in the form of a shareholder loan. This loan would either have to be repaid or included in the entrepreneur’s personal taxable income within 365 days after the end of the fiscal year. Another option that is sometimes underestimated is the individual pension plan (IPP), which is like a registered pension plan that the business owner sets up for him- or herself. This type of plan offers certain advantages: contributions can sometimes be higher than for an RRSP, and they are made by the company, which can deduct them from business income. An IPP is complex and costly, though, and requires professional expertise. As well, it implies that a salary will also be paid, since that is what the retirement pension will be based on.

How much?

Finally, the actual amount of compensation should be carefully calculated. Generally, an entrepreneur would want to keep enough money in the company to invest in its development. However, passive income rules would also have to be taken into account, and these do not encourage owners to retain large sums within the company. In fact, if retained amounts were generating investment income (or “passive income”), this would gradually lower the threshold for the small business tax rate offered to SMEs.

As we can see, these decisions touch on everything from business strategy and finances to investment and taxation. Don’t hesitate to consult your mutual fund representative, your financial security advisor and your tax specialist.

Sources

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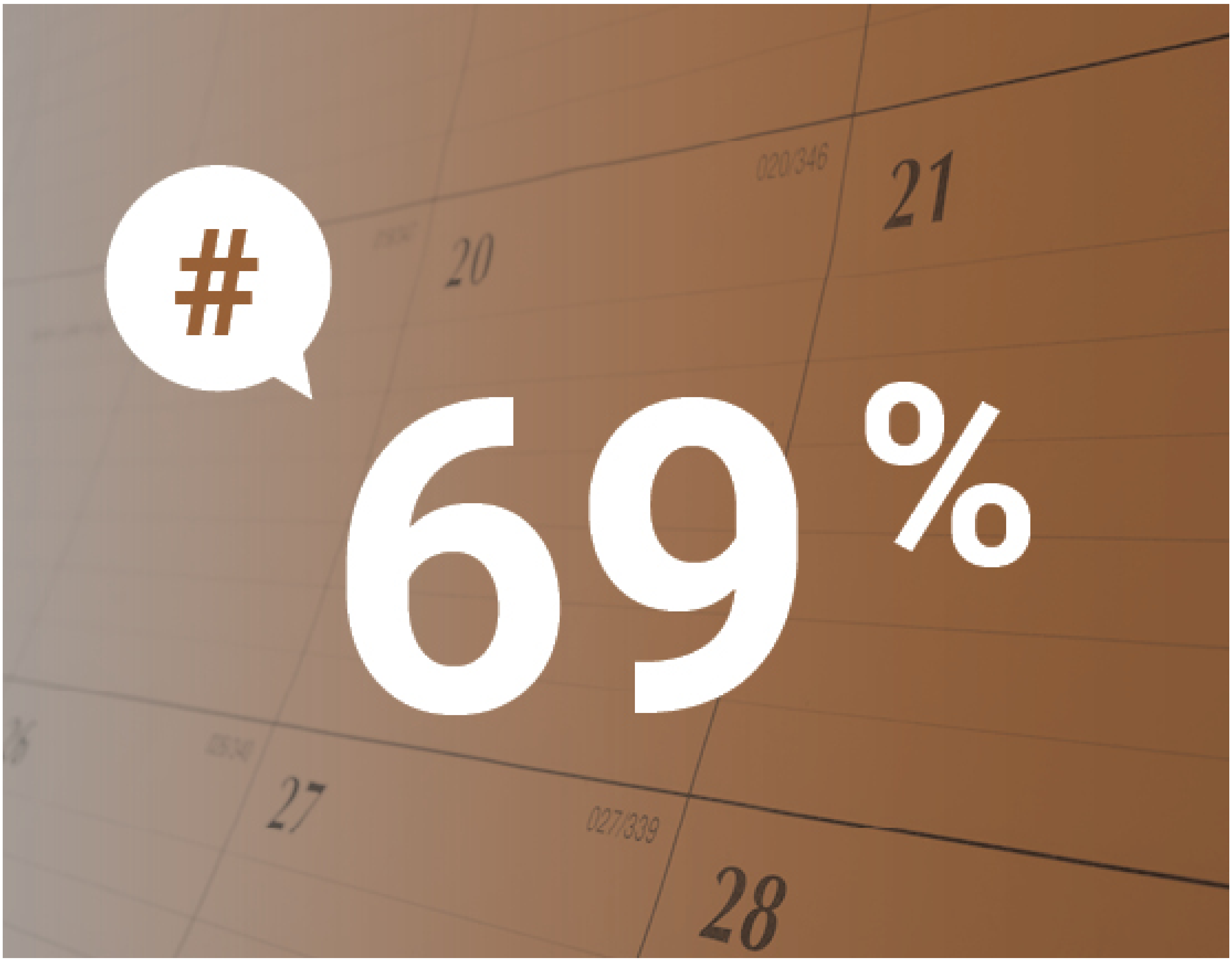

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