Owner - Manager Update

By:Matthew Getzler

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

____

As many readers can attest, it has long been a common practice for owner-managers to pay themselves sufficient salaries from their corporation in order to maximize his or her RRSP contributions in each year. However, as RRSP contribution limits increase and corporate tax rates decline, this longstanding practice warrants a re-visiting. Using 2011 maximum RRSP contributions and accounting for Canada Pension Plan (CPP), albeit on a limited basis, I recently compared the amount of dividends that must be distributed from corporate-earned income in order to leave an owner-manager in the same after-tax cash position he or she would be in if a salary sufficient to maximize RRSP contributions had been utilized. I then compared the future value of the “excess” retained in the corporation to the future value of the RRSP.

My calculations revealed an interesting result: in almost all cases, an owner-manager is better off using the dividend alternative than the salary alternative.

Technically speaking, some of the reasons for this result are as follows:

1. The cash in the corporation after distributing dividends is almost 20% higher than the amount of cash in the RRSP. This amount is largely attributable to neither the corporation nor its owner contributing to CPP.

2. When comparing the future value of the amounts in the corporation to the amounts in the RRSP, the preferred alternative will be largely dependant on the type of income earned by the corporation in the years of accumulation (interest, capital gains or dividend).

3. Where the corporation is earning interest income only (a highly unlikely situation), the salary alternative is preferable to the dividend alternative, but it’s close.

4. Where the corporation earns capital gains and/or dividend income, the dividend alternative is preferable to the salary alternative, and the difference may be substantial (especially where the corporation earns only capital gains).

5. Where the corporation is earning a mix of interest, capital gains, and dividends, the dividend alternative will almost always be preferred to the salary alternative (it is only when a very significant portion of the income is in the form of interest – again, a highly unlikely situation – that the salary alternative is preferred, albeit only marginally).

Despite these results, non-tax considerations should also be examined (i.e., saving for retirement, creditor protection) as such considerations do not always dovetail with tax savings. Accordingly, depending on such circumstances, the dividend alternative may not be best for the owner-manager, despite the tax advantages it presents.

For further information, please contact the author or any member of the Minden Gross tax group.