PORTER
HÉTU
INTERNATIONAL
Professional Services Group

The Abacus
ISSUE 66

PROFESSIONAL **STRENGTH** PERSONAL **SERVICE** PRACTICAL **SOLUTIONS**

Salary or dividends?

The way a bonus is paid has a significant effect on corporate and personal after-tax income.

LET'S SAY you're an owner-manager and you've just had a really good year. Profits are up significantly and you want to reward your employee shareholders with a bonus. But how? Salary or dividends? The answer to this age-old question is not as simple as it seems. It is even possible to receive remuneration that is a combination of salary and dividends. However, because every company and its shareholders have different needs, a one-size-fits-all approach to remuneration is not prudent.

Different tax effects

Salary and dividends differ with respect to taxation. A dividend is a per-share payout of retained earnings and is therefore not an expense and thus does not reduce pre-tax income. A salary bonus differs from a dividend in that it is an expense and thus reduces pre-tax income. Corporations, trusts, charities and a wide variety of other entities can also receive dividends.

Distributing a salary bonus effectively reduces pre-tax income by the amount paid. Thus, if a company pays out 100% of pre-tax earnings in the form of a salary bonus, the corporation may not be subject to income tax expense. On the other hand, if a company wishes to distribute the same dollar amount of earnings by declaring a dividend, the company must first pay corporate income tax. Assuming after-tax earnings of $100,000 and a tax rate of 15.5%, the cash outlay would be $118,343 (i.e., the distribution of the $100,000 of earnings in the form of a dividend bonus plus the $18,343 in income tax on those earnings in order to net $100,000 for the dividend payment).

Dividends are often cited as the best means of providing remuneration to the owner-manager since they do not attract as much personal income tax as salary. For example, a salary of $100,000 for a single individual would create a combined federal and provincial tax of $26,466 (Ontario), whereas an eligible dividend of $100,000 from an owner-managed business would generate a personal tax of $9,802; personal tax from an other than eligible dividend would be $16,693.

At first blush, an owner may be tempted to simply pay out all profits by dividend because of the significant personal tax savings. However, since dividends are paid from after-tax earnings, the combined tax in the case of an eligible dividend would amount to $28,145 ($18,343 + $9,802) and in the case of an other than eligible dividend the combined tax would be $35,036 ($18,343 + $16,693). Certainly there are other factors that come into play both on a corporate and personal level, but the example establishes that one should carefully consider the approach to be taken.

SEE SALARY OR DIVIDENDS P. 4

INSIDE THIS ISSUE

Income Tax SCAMS

Beware of telephone calls or emails from persons pretending to be CRA agents and asking for personal information or promising you a tax refund.

According to the Canada Revenue Agency (CRA), an increasing number of people are receiving telephone calls from persons falsely presenting themselves as CRA agents and aggressively asking for personal information such as credit card, bank account, passport and even social insurance numbers (SIN). Keep in mind that CRA already knows your SIN. This type of telephone scam—as well as other similar kinds of scam perpetrated through email—could result in identity theft and significant financial loss for unsuspecting taxpayers.

How a typical phone scam works

BOGUS CALLS HAVE A READILY RECOGNIZABLE STRUCTURE:

1 FALSE I.D.

A bogus caller identifies him- or herself as a "CRA agent", then provides a fake I.D. number and return telephone number within the local tax office area code.

2 BOGUS ACCUSATIONS & THREATS

The fraudster usually makes one or more of the following accusations—often in aggressive and threatening language:

- *"Your taxes are in arrears and outstanding amounts must be paid immediately or bank accounts, personal assets or businesses will be seized."* The amount is usually between $700 and $2,500, amounts small enough to be payable through a line of credit or a credit card.
- *"CRA has issued a warrant for your arrest or deportation because back taxes have not been paid and the police are on their way to your home or place of business."*
- *"You have been involved in a fraudulent activity and are under investigation."*
- *"Your tax returns have been audited and you owe money."*

3 PHONY GOOD NEWS

Instead of the above, the fraudster might suggest that, rather than being in trouble, *"You are about to receive a refund."* Usually the amount is small enough to be believable but large enough to be enticing. You may be told that the amount will be deposited directly into your bank account via an Interac transfer, but the caller needs your bank account number to make the direct deposit. The fraudster may also ask you for your social insurance number, driver's licence number and date of birth just to "confirm" they are talking to the right taxpayer. The risk is not just that the fraudster might access your bank account but that the fraudster now has some of your unique identifiers that can be used later to steal your identity.

4 FAKE REASSURANCES

The bogus caller counters objections by assuring the frightened taxpayer of one or more of the following:

- If full or partial payment is made they will not proceed with collection procedures that would freeze all bank accounts, seize your home or close your business.
- The "warrant" for these measures can be revoked and the police called off if the taxes are paid immediately. As a show of good faith, the taxpayer should provide a deposit.
- The CRA will take no further action if the taxpayer pays the arrears for the oldest one or two years immediately.

5 SHAM CONCLUSION

FInally, after making his or her "pitch", the scammer adds a tone of authenticity to the call by providing a fake telephone number for the taxpayer to call if they wish to confirm the call is really from the CRA. This is a false number to a fellow fraudster who simply answers the phone stating, *"Canada Revenue Agency, Collections Agent X speaking"*.

SEE INCOME TAX SCAMS P. 3

INCOME TAX SCAMS CONT'D FROM P. 2

How the CRA actually works

Taxpayers should know that the CRA does NOT and will NEVER:

- Request personal information by email
- Ask for driver's licence, health card, social insurance or passport numbers
- Leave, or ask you to leave, voicemail messages containing details of taxes owing or refunds available
- Discuss personal details of your tax situation with anyone other than you unless you have provided the appropriate authorization
- Make calls that threaten immediate arrest or seizure of bank accounts or other assets
- Send the police, or jail or deport anyone.

How you should react

If the phone call sounds too good to be true, or the "CRA agent" uses aggressive language, or if the "agent" asks for information you know is already on file with the CRA, HANG UP IMMEDIATELY! Do not engage in conversation, and do not answer any questions.

If you receive the phony request by email, **DO NOT CLICK THE LINK!** It could automatically download malware that could harm your computer and put your personal information at risk.

How to be proactive

If in doubt about the authenticity of an email or telephone call concerning your taxes, contact CRA or the Canadian Anti-fraud Centre for guidance:

Canada Revenue Agency
1 800 959-5525 for businesses
1 800 959-8281 for individuals
Canadian Anti-Fraud Centre
1 888 495-8501
www.antifraudcentre-centreantifraude.ca

For additional information on taxpayer fraud, visit the CRA website at **www.cra.gc.ca/security** ■

SALARY OR DIVIDENDS CONT'D FROM P. 1

Additional considerations

There are further issues that must be factored into the decision as to whether to pay dividends or salary:

- Dividends cannot be used to create any RRSP contribution room because they are not earned income.
- Dividends do not create any requirement for a contribution to the Canada Pension Plan by either the owner-manager or the employee because they are not earned income.
- Financial institutions often lend on the basis of earned income believing that salary is the only way to judge an individual's ability to pay. Attitudes in this area are certainly changing, but income based on corporate dividends may impact your ability to obtain personal mortgages or lines of credit.
- If the employee is unable to work because of an accident or some other event, a wage replacement amount may be difficult to calculate because dividends are not earned income.
- Income splitting that is possible by paying salary to family members employed in the business will be hampered if the family members are not shareholders since dividends are paid to shareholders on a pro rata basis.
- Insurance companies may not be willing to support benefit or disability programs if dividends paid to an organization's owner cannot be included in their definition of earned income.
- Receipt of dividends instead of salary may nullify other personal income tax deductions such as child care expense.
- Various provincial bodies may include dividends when calculating the employer's Workplace Safety and Insurance Board or Employer Health Tax liability.
- **Other concerns:** Eligible dividends cannot exceed the balance in the General Rate Income Pool (GRIP). Excess payments from the GRIP can result in penalties.

Three types of dividends

A business must be aware that there are three types of dividends an employee can receive from your corporation:

"ELIGIBLE" DIVIDENDS

Subject to a dividend gross-up of 38% and a federal dividends tax credit equal to 20.73% of the cash dividends; and provide a more beneficial tax rate.

REGULAR DIVIDENDS

Other than "eligible" dividends; subject to an 18% dividend gross-up and a federal dividends tax credit equal to 13% of the cash dividends; and provinces may have their own dividends tax credit rates, so check the rate in your province.

CAPITAL DIVIDENDS

Are received tax-free; and are paid from the company's capital dividends account, which includes the non-taxable portion of capital gains, life insurance proceeds, and capital dividends received from other corporations. ■

DOMENIC GALATI
CPA, CGA

Independent Member Firm
Porter Hétu *International*
Professional Services Group

510-3100 Steeles Ave W
Concord, ON L4K 3R1
Tel: (416) 745-0245
Email:
domenic@galaticga.com

VISIT US ONLINE
www.porterhetu.com

Independent member firms of **Porter Hétu *International*** offer a full range of professional services in accounting and auditing, management advisory, business plans and proposals, estate planning, tax planning, forensic accounting, mergers and acquisitions, business reorganization and more... Make a **Porter Hétu *International*** member firm your strategic partner. Call us today or visit **www.porterhetu.com** for a listing of all member firms.

To receive a free copy of the **Porter Hétu Tax Tips** booklet, visit **www.porterhetu.com** and click on the office nearest you for our email address. Or simply email us at: **taxtips@porterhetu.com** with your mailing address and a request for the tax tip booklet.

THE ABACUS IS PUBLISHED BY
PORTER HÉTU *INTERNATIONAL*

COORDINATION Flora Hugon
DESIGN JAM Design
FRENCH TRANSLATION Noëlla Bordage

Please send your comments or questions to Flora Hugon at fhugon@gbco.ca