BUSINESS WEALTH WATCH

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Owners of business failing to leverage company tax advantages to help them save for retirement

Many entrepreneurs don't realize that they have far more flexibility to keep more of their hard-earned money in their pockets.

Business owners and incorporated professionals, including lawyers, accountants and consultants, may find their greatest tax advantage lies in paying themselves through dividends, not salary, and investing the money that would normally go into an RRSP into their corporation, where it can be reinvested.

The problem is that many incorporated individuals don't know about this dividend approach and therefore aren't employing it. And it could be costing them tens of thousands of dollars every year.

For example, business owners in B.C. making less than $500,000 per year who pay themselves a salary, pay **Canada Pension Plan** (CPP) premiums and invest in RRSPs are paying more in taxes than necessary and losing retirement savings money than if they were to consider a more entrepreneurial approach to compensation and savings that only an incorporated business owner can enjoy.

Let me explain. Using the conventional "take a salary" approach, the owner of an incorporated business takes a salary from the business (high enough to provide maximum RRSP contribution room, which is typically $122,000), likely splits income with his or her spouse (paying them a justifiable salary) and both pay personal income tax.

Using a dividend strategy, the owner pays himself and his spouse dividends, rather than salary, taking enough to fund their personal living requirements but leaving the excess – some of which would have gone into RRSPs – in a corporate investment account, where it is invested. The corporation is taxed at the small-business rate, and the business owner and spouse income split to pay a lower rate of income tax on the dividends. The combined total tax using this strategy is lower than the personal income tax paid in the first scenario.

Other benefits to using the dividend approach:

■ it allows greater flexibility to split income between spouses, since **Revenue Canada** might question some salary divisions between spouses. On the other hand, income splitting using a dividend compensation approach is more conservative, as one doesn't need to justify the amount of dividends paid to a shareholder;

■ the business owner avoids paying CPP premiums, especially since entrepreneurs have to make both employee and employer contributions. Small-business owners might find they're better served by investing that money in their corporation, rather than giving it to the government to manage or control when they're able to receive it;

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■ whereas RRSP contributions must be transferred to an RRIF and withdrawals begin at a set age, investing corporately offers more control over when business owners get – and pay taxes on – their savings; and

■ saving outside of RRSPs offers flexibility with your choice of investments. For example, you can't invest in hard-asset real estate properties through your RRSP.

As with most tax strategies, however, there are some caveats.

The dividend approach is not a cookie-cutter tax-planning solution. If a company's pre-tax income exceeds $500,000, it might be better to employ a combination of dividends and salary strategies because corporations that exceed $500,000 in taxable income pay a higher rate – 26.5% versus 13.5% (based on B.C. rates) – and should consider paying themselves salary up to the level where RRSP contribution can be maximized, roughly $122,000.

Another important consideration would be creating the right corporate structure and, perhaps, including a family trust to facilitate income splitting and allow creditor protection of assets.

The dividend approach strategy to compensation is unique to business owners and incorporated professionals. It's an approach that many entrepreneurs can benefit from and should examine with their financial adviser and tax specialist. When coupled with good planning and smart investing, it can significantly accelerate wealth building and help business owners achieve retirement much sooner than they think. ■

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