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Get your hands on the corporation's income

By Florence Hui, CGA

If you have an unincorporated business, you may be considering incorporation to save on taxes. The combined federal and provincial corporate tax rate for small "Canadian-controlled private corporations" is about 16% for 2008 on the first $400,000 of active business income, and about 32% for income over $400,000. Compared to the 43% top personal marginal rate, these rates represent significant tax savings.

However, before you make your decision to incorporate, you should consult a professional accountant to help you determine if you should incorporate. Generally, if you rely on all of your business profits to support your personal cash flow needs, incorporation may not be a good idea. The cost of setting up and maintaining the corporation could outweigh the tax benefits. Only if you can leave some of your profits in the corporation to be reinvested, you may be able to take advantage of the tax savings.

After you incorporate, the income you earn through a corporation is no longer your "personal income". It is the corporation's income. Generally, you have two ways to take income out of a corporation, either as a salary or as dividends. If you just take money out of the corporation's bank account without reported it either as a salary or dividends, the money withdrew has to be treated as a loan owe by you. This withdrawal has to be paid back to the corporation to avoid potential tax consequences.

Salary: When a corporation pays you a salary, the corporation can deduct the amount paid as an expense. You need to report the salary as employment income in your personal tax return. However, if the corporation pays all of its profits to you as salary, you are in much the same position as if you earned the income without having a corporation.

Dividends: When you leave the profits in the corporation, the income is first taxed at the corporation level. After taxes are paid and the corporation distributes the after-tax income to you as a shareholder, the amount is called dividends. You need to report the dividends on your personal tax return. Dividends are not expenses and are not deductible to the corporation.

To decide whether taking money out as a salary or dividends depends on each person's specific situation, with many factors to consider. Therefore, you should ask a professional tax adviser to help you compare the total corporate and personal income tax you will pay if you earn income through a corporation.