

SUMMER 2015

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## the newsletter of Prentice Yates & Clark

### Salary or Dividends?

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

You are 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.

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.

#### Different Tax Effects

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.

#### Additional Considerations

- There are additional considerations that must be factored into the decision as to whether to pay dividends or salary.
- Because dividends are not earned income, they cannot be used to create any RRSP contribution room.
- Because dividends are not earned income, they do not create any requirement for a contribution to the Canada Pension Plan by either the owner-manager or the employee.
- 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.

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## Salary or Dividends?— continued

- 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 (WSIB) or Employer Health Tax liability.

### **An employee can receive three types of dividends.**

#### **Three Types of Dividends**

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

1. **“eligible” dividend:** (i.e., subject to a dividend gross-up of 38% and a federal dividend tax credit equal to 20.73% of the cash dividend) — as noted above, eligible dividends provide a more beneficial tax rate
2. **regular dividend:** (or an other than eligible dividend) subject to an 18% dividend gross-up and a federal dividend tax credit equal to 13% of the cash dividend — provinces may have their own dividend tax credit rates (Check the rate in your province.)
3. **capital dividend:** (capital dividends are received tax free) — this dividend is paid from the company's capital dividend account, which includes the non-taxable portion of capital gains, life insurance proceeds, and capital dividends received from other corporations

#### **Other Concerns**

Eligible dividends cannot exceed the balance in the General Rate Income Pool (GRIP). Excess payments from the GRIP can result in penalties.

#### **Talk to Your CPA**

Given the complexity of the decision as to whether salary, dividends or a mix of both is the best way to proceed, astute owners should meet with their CPA to discuss corporate and personal needs before a decision is made.

Your CPA understands the share structure of your company, the company's viability, and the overall remuneration needs of the shareholders. This insight, plus knowledge of the tax regulations and the tax software that can be used to simulate various scenarios, enables your CPA to assist you in making the right decisions as to the appropriate mix of salary or dividends. ♦

## Inside PYC

Congratulations to Paul Jaroszko, Colin Tozer and Sanjay Kiran on their respective weddings.

Congratulations to Garry Gatti and Aria Nassiri Afshar for completing all the CPA professional education program requirements and will be attempting the CFE in September.



## Auto Hacking

### **The Internet of Things is vulnerable. In theory, even your car could get hacked.**

In our society, Internet-enabled computers are literally everywhere. From a security perspective (and also generally), traditional computers like desktops and laptops have a mature software ecosystem; antivirus suites are not just widely available, a majority of computers have one that is up to date. Anti-malware apps are even available for the major mobile phone platforms; if you don't already have an antivirus for your mobile phone or tablet, get one.

What about other kinds of devices, i.e., the ones we tend not to think about? The Internet of Things (IoT), is a very broad category of Internet-enabled devices that tend to operate autonomously, ranging from home security systems, smart hydro meters and smart thermostats, to parking meters, cars and beyond. Yes, your car could, theoretically, be hacked.

#### **Attack Surfaces**

The concern of many researchers is that access to an IoT device may be compromised because of easy entry via “attack surfaces”, which is basically any method that could be used to communicate with the embedded computer. A complex device (e.g., a car) has many interfaces via electronic conveniences such as Bluetooth, Wi-Fi, cellular network, keyless entry systems and even tire pressure monitoring systems. It may then be possible to gain access through the backdoor, so to speak, into the vehicle's computers.

Indeed, at a Black Hat security conference in Las Vegas in 2014, two professional hackers, Charlie Miller and Chris Valasek, presented a 92-page paper that documented their review of 24 makes and models of vehicles and ranked their theoretical hackability. In addition to attack surfaces, the researchers examined the vehicles' internal network architecture (i.e., which components are able to directly communicate with each other) and 'cyberphysical' features (e.g., assisted parking and automated braking) a nefarious hacker could manipulate to create a potentially dangerous situation. Although none of the vehicles was actually hacked, the researchers demonstrated that not all cars are designed with network security in mind. It was discovered that the most vulnerable models were susceptible because they had wireless “attack surfaces” that were not insulated from the car's network.

## Auto Hacking — continued

Not only cars are susceptible: a 2014 study found that Internet of Things devices have on average 25 vulnerabilities each!

As a result of ongoing research and some news headlines, manufacturers are becoming aware of the potential for hackers to gain unauthorized access to these devices. News items question whether businesses should be concerned about cyber attacks on their vehicles or equipment. Pragmatically, the answer would be “no” simply because there is little financial incentive for anyone to hack into most of the vehicles or equipment business owners use; known exploits tend to be rather labourious and limited to one device at a time rather than many devices en masse. However, financial incentive is not always the motivation. Recent news snippets have demonstrated revenge and challenge can be motivators.

In Texas, a disgruntled ex-employee of a web-based immobilization system disabled some vehicles and left others with their horns honking continuously. In other controlled research situations, tire pressure monitoring systems were hacked and turned on warning lights and windshield wipers, while braking systems were disabled and engines stopped.

### Can Your Vehicles Be Hacked?

For the time being most researchers agree it is unlikely that businesses and consumers need to be concerned about vehicles being hacked and running amok. At the same time, however, they are urging vehicle owners to take a few precautions to safeguard against electronic mischief. A few suggestions include:

Ensure that passwords to an auto security and information service such as OnStar are not left in the vehicle.

Minimize the possibility of manipulation of your vehicle’s computer system by using only a reputable shop for your vehicle’s repairs.

Don’t be talked into installing aftermarket devices that may be able to track your movement or allow backdoor access to the vehicle’s driving functions thereby leaving you vulnerable to an outside party.

Always lock your vehicle to prevent tampering.

### Recommendations

Whether your business is already using Internet of Things devices, or is considering IoT, experts recommend:

Separate the IoT devices from the other devices on your network by using a firewall.

Consider security features when evaluating potential IoT products.

Configure security features like strong password requirements and two-factor authentication.

Regularly update the firmware/software on all devices, if available.

### The Future

The explosion of growth of the Internet of Things and the evolution of connectivity between humans and devices mean that devices will become more prevalent and potentially vulnerable to cyber attack. It may take some time for the IoT industry to catch up with the security standards and processes that have developed since personal computers “hooked-up” to the Internet. Unlike laptops or mobile phones, there is currently no antivirus available for your car or thermostat. Most security recommendations for IoT devices are similar to the best practices we already follow today for computers and physical infrastructure. ♦

## You’re Hired

### Human rights legislation governs all hiring practices.



Finding good employees is a tough job at any time but especially when you are seeking those with special skills and the right attitude. You have to ask a job candidate a lot of questions, not only to determine their qualifications and experience, but also to understand the individual’s character and personality. Can this person work with our team?

### Comply with Legislation

The hiring process must, however, comply with the *Canadian Charter of Rights and Freedoms* section of the Constitution as well as other federal and provincial Acts. But human rights legislation makes many questions illegal. The purpose behind these Acts is to ensure all individuals have an equal opportunity to live their lives as they see fit, free from discrimination based on the general categories of age, sex, marital/family status, race, colour, ancestry, place of origin, creed, religion, citizenship, nation or ethnic origin, sexual orientation and handicap/disability. In fact, rejection of a job applicant for any reason that contravenes legislation could lead to an embarrassing investigation by the Canadian Human Rights Commission.

### Types of Questions to Avoid

The following categories must be avoided:

- age
- country of birth
- nationality
- first language
- race.

### Age

In 1971, Robert Neil Butler coined the term “ageism” to describe discrimination against seniors that arose from what he noted as a prejudice toward older people, old age and the aging process in general. Over time, the term has come to identify a prejudice against the young as well as the elderly. Thus, interviewers should avoid asking questions that lean toward determining age, such as:

- How old are you?
- When did you graduate from high school/university?
- When were you born?

### Family

Questions about living arrangements or family issues are also taboo. It is not good form to ask the following questions:

- Are you married, have a partner, live common-law?
- How many children do you have?
- Are children expected in the near future?
- Do you plan to have more children?
- Do you have child care in place?

### Memberships

Determining whether an individual is “the wrong type” can possibly be determined by asking questions about clubs and associations. Such questions in the first instance may provide answers that create a predetermined bias or prejudice. We all draw conclusions about a person if we discover they like horses, motorcycles or wear high heels. To avoid the appearance of prejudicial enquiry avoid asking:

- Are you currently a union member?
- Are you a member of any social clubs?

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## You're Hired—continued

Depending on the answer, the interviewer may automatically infer the individual is of a certain ethnic, religious, political or other background, and then stereotype the person.

### Profile Prejudice

Roger Ailes, author of *You Are the Message*, is quoted as saying; "You've got just seven seconds to make the right first impression." Whether in seven, 10 or 30 seconds, first impressions are formed rather quickly because it is easy to fall back on past experience, stereotypes and prejudices. These can be difficult to overcome since no one can function without some preconceived idea of how the world around them should look and behave. But asking questions that imply a prejudiced profile is not permissible:

- What is your weight?
- How tall are you?

### **Drug or alcohol dependence are disabilities.**

### Disability Discrimination

Article 25 of the *Canadian Human Rights Act* defines disability as "any previous or existing mental or physical disability and includes disfigurement and previous or existing dependence on alcohol or a drug". Nevertheless, there may be lingering displays of disability discrimination that may offend should an interviewer ask:

- Do you have a disability?
- Do you mind filling out this medical history?
- Do you party a lot?
- Is there a history of (mental) illness in your family?
- Have you seen a doctor in the last year?
- When did you lose your thumb?
- Do we need to modify chairs, washrooms, desks etc. to accommodate you?

### Criminal Record

Many employers need to ensure employees are bondable and insurable. However, an employer should be cautious about asking:

- Have you ever been arrested?

### Gender

Gender-based hiring is discriminatory. Although an applicant's gender may seem obvious to the eye, it is not always. Employers may not ask:

- Are you male or female?
- What are your cohabitation arrangements?
- What is the name of the person you live with?

### Racial Profiling

Race may be defined as a human group sharing distinct physical features such as skin colour, skin tone, eye and hair colour, as well as a tendency to develop certain diseases and cannot be changed or disguised. Don't ask:

- What is your race?
- What is your skin colour?
- What colour are your eyes?
- Do you have black, blonde, brown hair?

### Equality

Section 15 (1) of the *Canadian Charter of Rights and Freedoms* states that every individual is "equal before and under the law and has the right to the equal protection and equal benefit of the law without discrimination and, in particular, without discrimination based on race, national or ethnic origin, colour, religion, sex, age, or mental or physical disability".

### Religion

Interviewers must not ask about religious affiliation:

- What is the name of your Imam?
- What religious holidays do you observe?
- Do you go to church?

### Exceptions

There are some apparent exceptions to this legislation under special circumstances (i.e., if there is a "bona fide occupational requirement" to do the job). For example, the owner of a Greek restaurant would be allowed to hire Greek-speaking wait staff to the exclusion of other applicants. In other cases, it must be established that it would cause undue hardship and be financially prohibitive to accommodate the worker and still maintain health and safety in the workplace.

### It's the Law

The purpose of human rights legislation is to prevent discrimination based on what people cannot change about themselves: gender, age, skin colour, ethnicity, etc. Laws and regulations remove prejudicial selection and base hiring on the qualifications of education and experience. As such, the hiring process must be designed to select employees on the basis of genuine qualifications relevant to job performance and on the basis of individual merit rather than group generalizations or stereotypes. ♦



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