

# RRSPs for small business owners

As a small business owner, your corporation may produce surplus above what is needed for your business or personal lifestyle.<sup>1</sup> If you want to save the surplus for future use, you have options available. You can either retain in the corporation or remove and invest personally. This article compares retaining the surplus in your corporation to removing and investing in a registered retirement savings plan (RRSP).<sup>2</sup> As seen below, maximizing your RRSPs makes sense for most business owners given a sufficient time horizon.

## The potential tax deferral

Many small businesses in Canada benefit from low tax rates on active business income (ABI). There is a further reduction known as the small business deduction (SBD) up to a threshold. The SBD results in significantly lower tax rates than the general ABI tax rate. In 2023, combined federal and provincial/territorial tax rates on SBD income range from 9%-12.20% on the first \$500,000.<sup>3</sup> Compare this to 23%-31% on general ABI above the threshold.

On the other hand, your personal tax rates can exceed both the SBD and general ABI tax rates in many cases. For ordinary income, the highest combined marginal tax rates average 50% across Canada in 2023. The highest combined rates are approximately 28%-46% for eligible dividends and 37%-49% for non-eligible dividends.<sup>4</sup> The lower personal tax rate on dividends reflect the corporate tax already paid.

Upfront, the lower corporate tax rates suggest there is a tax deferral advantage for retaining funds inside your corporation. However, having a lower tax rate inside the corporation does not automatically result in a deferral advantage. In fact, as seen below, your RRSP will initially have more invested when compared to corporate investing. Regardless, having more invested upfront does not always result in more to you when you withdraw the funds. The goal is to have more after-tax to you personally when you choose to liquidate the investment and distribute proceeds. The key items that influence the analysis include:

- Corporate tax rate on ABI (general ABI or SBD tax rates);
- Personal tax rate now versus in the future (whether you are in the same, lower or higher tax bracket when you invest compared to when you liquidate the investment);
- Investment vehicle chosen personally (RRSP, tax-free savings account (TFSA) or personal non-registered);
- Form of investment income generated (interest, dividends, capital gains, or deferred gains); and
- Time horizon (the length of time the funds stay invested).

## Investment vehicle characteristics

Corporate investing compared to RRSPs will not result in an upfront tax deferral for the corporate investment. Removing funds to invest in RRSPs is tax neutral. That is, salary is deductible for your corporation and deductible for you when you contribute to an RRSP. So, the RRSP will have more invested upfront compared to retaining inside the corporation. Thereafter, growth inside the RRSP is tax deferred, but you pay tax on the entire amount when withdrawn.

Alternatively, retaining surplus from active operations inside your corporation initially results in tax at the active tax rates mentioned above. Your corporation then pays tax on investment income at passive investment tax rates.<sup>5</sup> When your corporation rebalances or liquidates the investment, it can pay capital gains tax as well. The non-taxable portion of the capital gains credits the notional capital dividend account (CDA). A positive balance in the CDA allows your corporation to pay tax-free dividends to you as shareholder. Passive investment tax also generates a credit to notional accounts known as the refundable dividend tax on hand (RDTOH). Your corporation recoups RDTOH when it pays taxable dividends to you as shareholder.<sup>6</sup> These are all forms of integration in the Income Tax Act. Integration attempts to reduce double taxation when funds flow through your corporation to you. As a summary:

	RRSP	Corporate
<b>Tax prior to investing</b>	Tax deferred - deductible for your corporation when paid as salary and deductible for you when contributed to your RRSP	Corporate tax on business income at ABI tax rates (whether SBD or general ABI tax rates)
<b>Tax on growth while invested</b>	Tax deferred	Interest, dividends and capital gains taxed as passive investment income when incurred
<b>Tax inside the vehicle upon disposition</b>	Tax deferred	Capital gains taxed as passive investment income inside the corporation when you liquidate or rebalance the investment
<b>Personal tax on removal</b>	Fully taxable as ordinary income	Tax-free capital dividends and taxable dividends with gross-up and dividend tax credits applied <sup>7</sup>
<b>Contribution limits</b>	18% of prior year earned income up to \$30,780 (2023)	N/A
<b>Age limits</b>	Must convert to income stream at the end of the year in which you turn 71	N/A

This leads to the ultimate question. **Does the tax deferral inside the RRSP result in more after-tax to you when you liquidate the investment and distribute the proceeds?**

## Comparing the options

To see the tax deferral and integration in action, we analyse Andre's situation. We assume Andre is a resident of Ontario for tax purposes at the highest tax bracket. His corporation is also resident in Ontario and has \$10,000 before-tax surplus. Andre does not need the funds for the business or personal lifestyle and wants to invest for the future.

If Andre's corporation pays him a salary, it deducts \$10,000 from the corporation's pre-tax profits (reducing it to nil). Andre receives the \$10,000 and contributes the entire amount to an RRSP.<sup>8</sup> The result - Andre invests \$10,000 in an RRSP.

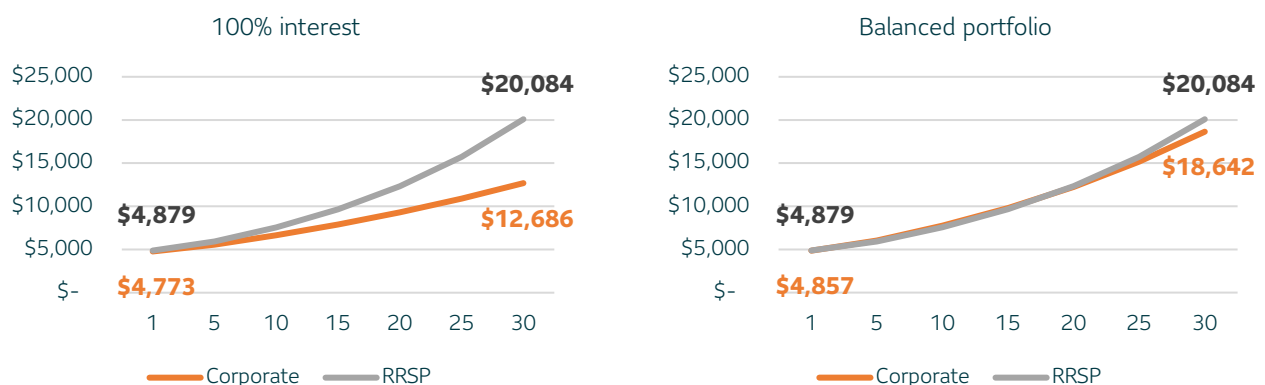
If Andre's corporation retains the surplus, the after-tax amount available to invest depends on the corporation's tax rate:

- **SBD tax rates.** The \$10,000 profit has 12.2% corporate taxes, leaving \$8,780 available to invest.
- **General ABI tax rates.** The \$10,000 profit has 26.5% corporate taxes leaving \$7,350 available to invest.

The corporation then invests the after-tax amount subject to corporate investment tax rates as explained above.

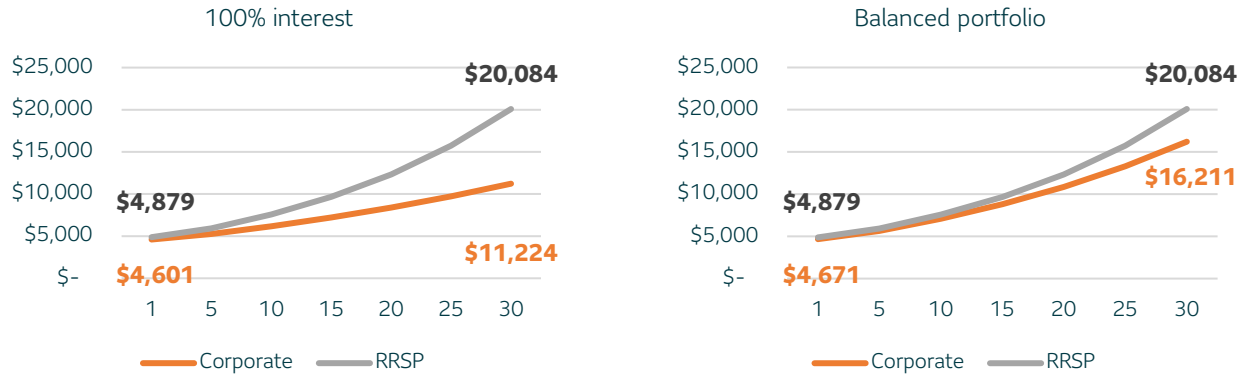
To compare apples to apples, Andre invests the after-tax amount in the same investment either inside the corporation or RRSP. We look at both a 100% interest-producing portfolio and a hypothetical balanced portfolio.<sup>9</sup> To make it a fair comparison, we need to look at the after-tax value of each option to Andre personally. Therefore, we need to collapse the RRSP and remove the funds from the corporation.<sup>10</sup>

**At SBD tax rates initially, the after-tax amount available to Andre over time is as follows:**



When the corporation initially pays tax at SBD tax rates, the RRSP begins to outperform right from the beginning on the 100% interest portfolio. The balanced portfolio is almost equal but after time the RRSP outperforms. For Andre, it takes 21 years for the balanced RRSP to produce a noticeable difference in the after-tax amount.<sup>11</sup>

At general ABI tax rates initially, the after-tax amount available to Andre over time is as follows:



Similar to the SBD tax rates analysis, the RRSP begins to outperform right from the beginning for the 100% interest portfolio. The balanced portfolio takes less time for the RRSP to outperform than when the corporation initially pays tax at SBD tax rates. For Andre, it takes one year. This makes sense since the general ABI corporate tax rate is higher than the SBD tax rate. So, there is less to retain and invest in the corporation at the beginning compared to the RRSP.

So, what's the outcome for Andre?

- **100% interest portfolio.** If Andre is a conservative investor, the RRSP will likely provide more after-tax.
- **Balanced portfolio.** When the corporation initially pays tax at SBD tax rates, the RRSP and corporate investing provide similar after-tax amounts to Andre in earlier years. Andre needs 21 years for the RRSP to outperform when the corporation initially pays tax at SBD tax rates. However, when the corporation initially pays tax at general ABI tax rates, the RRSP will likely provide more after-tax from the beginning.

Now let's look at how the same investment performs across Canada at different tax rates.

## If you're in the same tax bracket when removing the funds

Below is a summary of the time needed across Canada for the RRSP to outperform the corporate investment. In all cases, we assume you remain in the same tax bracket throughout your lifetime. We display the time needed assuming you are at a \$50,000, \$100,000 or the highest tax bracket during your lifetime.

### SBD tax rates initially – years needed for RRSP to outperform corporate investment

	100% interest income portfolio			Balanced portfolio		
	\$50k tax bracket	\$100k tax bracket	Highest tax bracket	\$50k tax bracket	\$100k tax bracket	Highest tax bracket
BC	1	1	1	5	11	22
AB	2	2	1	9	11	18
SK	3	3	3	13	16	21
MB	2	1	1	9	13	18
ON	1	1	1	6	13	21
QC	1	1	1	1	9	17
NB	2	2	2	10	14	21
NS	2	2	2	9	13	20
PEI	1	1	1	7	13	18
NL	2	2	2	7	9	18
YT	2	1	1	8	11	18
NWT	6	7	7	14	19	24
NU	1	1	1	4	5	10

When your corporation initially pays tax at SBD tax rates, the result is:

- It takes little time for the RRSP to outperform when invested in a 100% interest portfolio;
- The lower the amount of interest income, the better the corporate investment performs. However, even for a balanced portfolio, the RRSP outperforms over time.<sup>12</sup>

### General ABI tax rates initially – years needed for RRSP to outperform corporate investment

100% interest income portfolio				Balanced portfolio			
	\$50k tax bracket	\$100k tax bracket	Highest tax bracket		\$50k tax bracket	\$100k tax bracket	Highest tax bracket
BC	1	1	1	BC	1	2	5
AB	1	1	1	AB	1	1	1
SK	1	1	1	SK	1	1	1
MB	1	1	1	MB	1	1	1
ON	1	1	1	ON	1	1	1
QC	1	1	1	QC	1	1	1
NB	2	2	2	NB	3	4	7
NS	1	1	1	NS	1	1	1
PEI	1	1	1	PEI	1	1	1
NL	1	1	1	NL	1	1	1
YT	1	1	1	YT	1	1	3
NWT	1	1	1	NWT	1	3	4
NU	1	1	1	NU	1	1	1

When your corporation initially pays tax at general ABI tax rates, it takes little time for the RRSP to outperform for either portfolio. Only BC, NB, YT and NWT need more than 1–2 years for the balanced portfolio. Even then, it doesn't take significant time. So, investing in an RRSP makes sense for most.

### If you're in a lower tax bracket when removing the funds

Not everyone stays at the same tax bracket during their lifetime. You may drop tax brackets from when you invest the funds to when you remove the funds. In this case, both the RRSP and the corporate investment will give more after-tax income to you. However, the tax bracket when you liquidate determines the time needed for the RRSP to outperform.

For example, assume you invest at the highest tax bracket and liquidate at the \$50k tax bracket. The balanced portfolio RRSP will outperform in six years in Ontario. This is the same time needed when you start and remain in the \$50k tax bracket during your lifetime.

As you drop tax brackets, the time needed for the RRSP to outperform decreases. The more tax brackets you drop when you remove the funds, the less time the RRSP needs to outperform. The time shown on the "highest tax bracket" column is the longest time needed for that form of investment.

### If you're in a higher tax bracket when removing the funds

You may also increase tax brackets from when you invest to when you remove the funds. In this case, both the RRSP and the corporate investment will give less after-tax income to you. However, the tax bracket when you liquidate continues to determine the time needed for the RRSP to outperform.

As you increase tax brackets, the time needed for the RRSP to outperform the corporate investment increases. The time shown on the above charts for each tax bracket represents the time needed. The time shown on the "highest tax bracket" column is the upper limit needed for that form of investment.

## Summary

Taking all the above into consideration, we summarize as follows:

Your tax bracket	Corporation initially pays tax at SBD tax rates	Corporation initially pays tax at general ABI tax rates
Same tax bracket when funds removed	<b>Maximize RRSP if time permits</b> 100% interest: 1-3 years for most (6-7 for NWT) Balanced: 4-24 years	<b>Maximize RRSP</b> 100% interest: 1-2 years Balanced: 1 years for most (BC, NB, YT and NWT may need time)
Lower tax bracket when funds removed	<b>Maximize RRSP if time permits</b> (the lower your tax bracket, less time needed)	<b>Maximize RRSP</b> (BC, NB, YT and NWT may need time)
Higher tax bracket when funds removed	<b>Maximize RRSP if time permits</b> (the higher your tax bracket, more time needed)	<b>Maximize RRSP</b> (BC, NB, YT and NWT may need time)

## Other considerations

In addition to the above, keep in mind the following considerations:

- Goal for the investment (short term versus long term);
- Loss of income tested benefits in retirement (grossed up dividends increase net income);
- Creditor protection (corporate funds may be exposed);<sup>13</sup>
- Available income splitting rules in retirement (eligible pension income for RRSPs compared to tax on split income rules for corporate funds);
- Flexibility to determine income (RRSPs have forced income after age 71);
- Loss of low SBD tax rate when accumulating passive income inside your corporation;
- Corporate structure and post-mortem planning when retaining funds inside corporation;
- Need to recoup RDTOH inside the corporation.

## Summary

Saving for future income needs requires you to plan and weigh the options available to you. Since RRSPs are a long-term retirement investment vehicle, removing corporate funds to invest in RRSPs makes sense for many. However, there is no one size fits all solution. It depends on corporate tax rates, personal tax rates (now and in the future) and timing for the funds. Use the above as a guideline to make an informed decision particular to your stated goals and objectives.

### Disclaimer

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<sup>1</sup> Determining whether to remove the funds as salary or dividends for current lifestyle needs is a different analysis than saving for future needs. For an analysis on salary versus dividends for current needs, see our article titled "*Salary/bonus or dividends*".

<sup>2</sup> For an analysis on retaining inside the corporation versus saving inside a TFSA see our companion article titled "*TFSAs for small business owners*".

<sup>3</sup> Thresholds across Canada for SBD income are all \$500,000 other than in Saskatchewan where the threshold is \$600,000. This results in a hybrid federal and provincial tax rate of 15% for ABI between \$500,000 and \$600,000 in Saskatchewan.

<sup>4</sup> A Canadian Controlled Private Corporation generally pays eligible dividends from corporate profits subject to general ABI tax rates and non-eligible dividends from corporate profits subject to SBD tax rates.

<sup>5</sup> Passive investment tax rates range between 46.67% and 54.67% across Canada in 2023. Capital gains tax rates are half of the passive investment tax rate, resulting in tax rates that range between 23.34% and 27.34%. Taxable Canadian dividends have a 38.33% tax rate.

<sup>6</sup> As of 2019 there are two notional RDTOH accounts that track different forms of investment income – eligible RDTOH (eRDTOH) and non-eligible RDTOH (nRDTOH). Recouping the eRDTOH and nRDTOH is subject to ordering rules beyond the scope of this article.

<sup>7</sup> Dividends from your corporation are grossed-up (15% for non-eligible dividends and 38% for eligible dividends) and a combined federal and provincial dividend tax credit is applied. The gross-up and dividend tax credit is a form of integration to reflect the corporate taxes already paid on dividend distributed to you. Your corporation will also recoup RDTOH when it pays a taxable dividend to you as shareholder at a rate of \$1 for every \$2.61 in taxable dividends.

<sup>8</sup> We assume Andre has the cash flow to supplement any withholding or payroll tax.

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<sup>9</sup> Both portfolios use a 5% average rate of return. The interest-producing portfolio is 100% interest. The balanced portfolio produces an equal amount of interest, dividends, capital gains and deferred gains.

<sup>10</sup> For the RRSP, we assume Andre withdraws the entire amount at the highest tax bracket. For the corporate investment, we assume the corporation liquidates the investment, pays capital gains tax and recoups all RDTOH. We also assume the corporation pays eligible, non-eligible and capital dividends based on their notional account balances accumulated on the invested funds.

<sup>11</sup> Throughout this analysis, we require more than 1% difference in the after-tax amount to Andre when compared to the original surplus to "outperform".

<sup>12</sup> Your type of investment should meet your risk tolerance. Therefore, we do not recommend choosing non-interest producing investments outside of your risk tolerance solely to produce a better tax result. Corporate class mutual funds can reduce interest-producing investments. However, distributions on such investments can vary and may still result in tax for the corporate investment.

<sup>13</sup> RRSPs and RRIFs have potential protection from federal bankruptcy claims. Further, some provinces provide creditor protection to RRSPs and RRIFs from general creditors outside of bankruptcy situations during lifetime and/or at death. Finally, RRSPs and RRIFs purchased from an insurance company that name a protected class beneficiary may benefit from creditor protection.