Sun Life

TFSAs for small business owners

As a small business owner, your corporation may produce surplus above what is needed for your business or personal lifestyle.[1] 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 tax-free savings account (TFSA).[2] As seen below, the analysis depends mainly on your time horizon and current and future tax brackets. However, maximizing your TFSA makes sense for many business owners given sufficient time.

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.[3] 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.[4] The lower personal tax rate on dividends reflect the corporate tax already paid.

The difference between the higher personal tax rates and lower corporate tax rates may result in a tax deferral. If the corporate tax rate is lower than your personal tax rate, there is more after-tax to invest in your corporation. Across Canada, the potential deferral ranges from 32.5%-42.5% for SBD income and approximately 17.5%-27% for general ABI income.

To calculate your potential deferral, subtract your corporation's tax rate from your current personal tax rate. However, having a lower tax rate inside the corporation does not automatically result in a deferral advantage. 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 tax deferral 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 (registered retirement savings plan (RRSP), 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 may result in an upfront tax deferral compared to investing in a TFSA. Removing funds to invest in a TFSA results in tax at your personal tax rate. So you will have more invested upfront in the corporation if your personal tax rate exceeds the corporate tax rate. Thereafter, growth inside the TFSA is tax-free, and all withdrawals are tax-free.

Alternatively, retaining surplus from active operations inside your corporation initially results in tax at the active rates mentioned above. Your corporation then pays tax on investment income at passive investment tax rates.[5] 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.[6] 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:

	TFSA	Corporate
Tax prior to investing	Personal tax at your tax bracket to receive funds from corporation. Corporate tax on business income at ABI tax rates if your corporation pays you a dividend. No corporate tax if your corporation pays you salary	Corporate tax on business income at ABI tax rates (whether SBD or general ABI tax rates)
Tax on growth while invested	Tax free	Interest, dividends and capital gains taxed as passive investment income when incurred
Tax inside the vehicle upon disposition	Tax free	Capital gains taxed as passive investment income inside the corporation when you liquidate or rebalance the investment
Personal tax on removal	Tax free	Tax-free capital dividends and taxable dividends with gross-up and dividend tax credits applied[7]
Contribution limits	$6,500 annually (2023) Cumulative limit of $88,000[8]	N/A
Age limits	Contribution room accrues only to those 18 and older	N/A

This leads to the ultimate question. **Does the corporate tax deferral offset tax-free growth in the TFSA to provide 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 pays tax at his tax rate of 53.53%.[9] The result - Andre invests $4,647 in a TFSA.

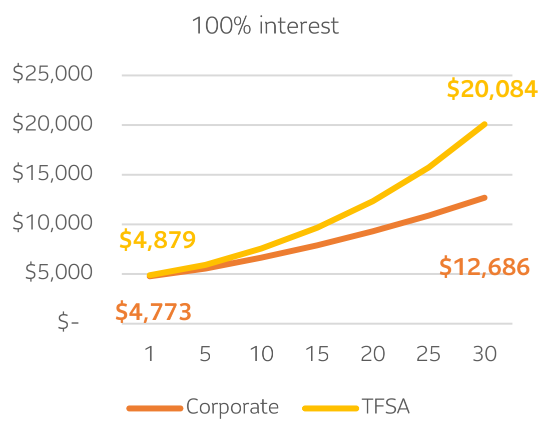
If Andre's corporation retains the surplus, the after-tax amount available to invest depends on the corporation's tax rate:

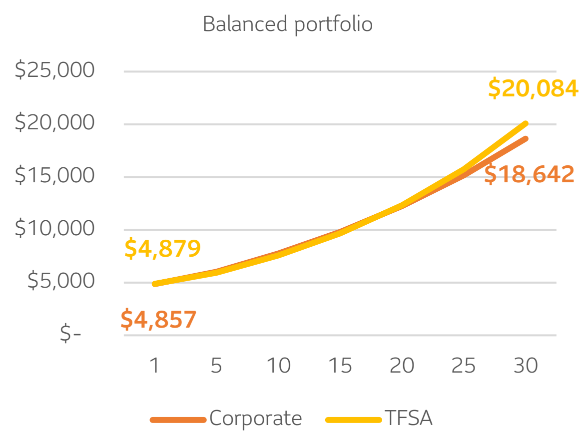
- **SBD tax rates**. The $10,000 profit has 12.2% corporate taxes, leaving $8,780 available to invest.
- **General ABI tax rates**. The $10,000 profit has 26.5% corporate taxes leaving $7,350 available to invest.

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

To compare apples to apples, Andre will invest the after-tax amount in the same investment either inside the corporation or TFSA. We look at both a 100% interest-producing portfolio and a hypothetical balanced portfolio.[10] 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 remove the funds from the TFSA and corporation.[11]

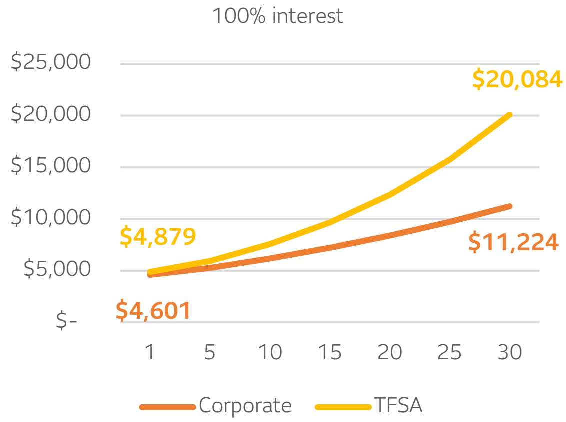
At SBD tax rates initially, the after-tax amount available to Andre over time is as follows:

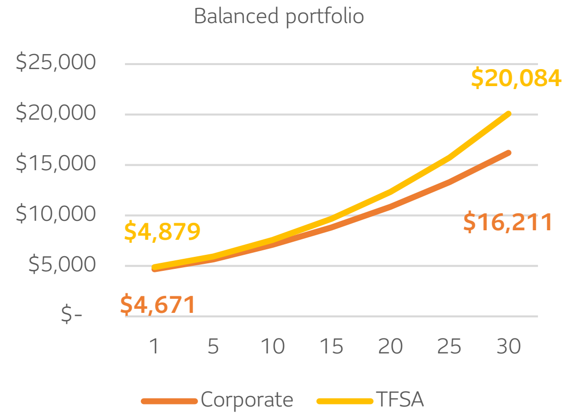




When the corporation initially pays tax at SBD tax rates, the TFSA begins to outperform right from the beginning on the 100% interest portfolio. The balanced portfolio is almost equal but after time the TFSA outperforms. For Andre, it takes 21 years for the balanced TFSA to produce a noticeable difference in the after-tax amount.[12]

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 TFSA begins to outperform right from the beginning for the 100% interest portfolio. The balanced portfolio takes less time for the TFSA 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, the corporate tax deferral advantage is smaller at the beginning.

So, what's the outcome for Andre?

- **100% interest portfolio.** If Andre is a conservative investor, the TFSA will likely provide more after-tax.
- **Balanced portfolio**. When the corporation initially pays tax at SBD tax rates, the TFSA and corporate investing provide similar after-tax amounts to Andre in earlier years. Andre needs time for the TFSA 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 TFSA 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 your TFSA 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 TFSA to outperform corporate investment

100% interest income portfolio

	$50k tax bracket	$100k tax bracket	Highest tax bracket
BC	1	1	1
AB	2	2	1
SK	3	3	3
MB	2	1	1
ON	1	1	1
QC	1	1	1
NB	2	2	2
NS	2	2	2
PEI	1	1	1
NL	2	2	2
YT	2	1	1
NWT	6	7	7
NU	1	1	1

Balanced portfolio

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

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

- It typically takes little time for the TFSA to outperform when invested in a 100% interest portfolio;
- The lower the level of interest income, the better the corporate investment performs. However, even at a balanced portfolio, the TFSA outperforms over time.[13]

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

100% interest income portfolio

	$50k tax bracket	$100k tax bracket	Highest tax bracket
BC	1	1	1
AB	1	1	1
SK	1	1	1
MB	1	1	1
ON	1	1	1
QC	1	1	1
NB	2	2	2
NS	1	1	1
PEI	1	1	1
NL	1	1	1
YT	1	1	1
NWT	1	1	1
NU	1	1	1

Balanced portfolio

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

When your corporation initially pays tax at general ABI tax rates, it takes little time for the TFSA 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.

How does that compare to investing in RRSPs? If you remain in the same tax bracket during lifetime, the time you need for the TFSA to outperform the corporate investment mirrors RRSPs.[14] In fact, the TFSA and the RRSP will provide you with the same amount after-tax when liquidated. This makes sense because RRSPs and TFSAs both grow without tax and your tax rate remains unchanged.

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, the corporate tax deferral becomes more relevant. That is, you remove funds at a higher tax rate to invest in a TFSA. However, you remove corporate funds at a lower tax rate.

When your corporation initially pays tax at SBD tax rates, the TFSA typically needs significant time to outperform the corporate investment for both portfolios. This makes sense because at SBD tax rates, the corporate tax deferral advantage is larger. For example:

- <u>100% interest portfolio</u> –the TFSA needs between 3-30 years across Canada to outperform the corporate investment; and
- <u>Balanced portfolio</u> –the TFSA needs between 21-30+ years across Canada to outperform the corporate investment.

The more tax brackets you drop when you remove the funds, the more time the TFSA needs to outperform.

When your corporation initially pays tax at general ABI tax rates, the TFSA takes less time to outperform than at SBD tax rates. This makes sense because the corporate tax deferral advantage is smaller. However, in many cases, the TFSA still requires significant time to outperform the corporate tax deferral. For example:

- <u>100% interest portfolio</u> - the TFSA needs between 1-23 years across Canada to outperform the corporate investment; and
- <u>Balanced portfolio</u> –the TFSA needs between 1-30+ years across Canada to outperform the corporate investment.

The more tax brackets you drop when you remove the funds, the more time the TFSA needs to outperform. Only when you drop from the highest to the second highest tax bracket is the lower time frame applicable. Even if you aren't in the highest tax bracket when you invest the funds, the TFSA needs time to outperform. Therefore, if you expect to be in lower tax bracket in when you remove the funds, the TFSA may not outperform the corporate deferral.

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, the TFSA tax-free growth may become more relevant. That is, you remove funds at a lower tax rate to invest in a TFSA. However, you remove corporate funds at a higher tax rate.

Below is a summary of the time needed across Canada for your TFSA to outperform the corporate investment. In all cases, we assume you start below the highest tax bracket when you invest in the TFSA. We show the time needed assuming you increase tax brackets when you liquidate the investment.

Both SBD and general ABI tax rates initially – years needed for TFSA to outperform corporate investment

100% interest income portfolio

	$50k to $100k tax bracket	$100k to $152k tax bracket	2nd highest to highest tax bracket
All provinces and territories	1	1	1

Balanced portfolio

	$50k to $100k tax bracket	$100k to $152k tax bracket	2nd highest to highest tax bracket
All provinces and territories	1	1	1

In all of the above cases, the TFSA outperforms right from the beginning. This is true whether your corporation initially pays tax at SBD or general ABI tax rates.

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	**Maximize TFSA if time permits** 100% interest: 1-3 years for most (6-7 for NWT) Balanced: 4-24 years	**Maximize TFSA** 100% interest: 1-2 years Balanced: 1 years for most (BC, NB, YT and NWT may need time)
Lower tax bracket when funds removed	**Retaining in the corporation may provide more**. Depends on time and investment income but TFSA needs significant time. 100% interest: 3-30 years Balanced: 21-30+ years (the lower your tax bracket, more time needed)	**Retaining in the corporation may provide more**. Depends on time and investment income but TFSA needs significant time. 100% interest: 1-23 years Balanced: 1-30+ years (the lower your tax bracket, more time needed)
Higher tax bracket when funds removed	**Maximize TFSA** Only 1 year needed	**Maximize TFSA** Only 1 year needed

Although RRSPs are a long-term retirement investment vehicle, TFSAs are not always the same. Many use a TFSA for short-term goals and needs. As such, your goal and objective relating to the TFSA will be key.

Other considerations

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

- "use it or lose it" function of TFSA;[15]
- Goal for the investment (short term versus long term);
- Loss of income tested benefits in retirement (grossed up dividends increase net income but TFSA does not);

- Creditor protection (corporate funds may be exposed);[16]
- Available income splitting rules in retirement (tax on split income rules for corporate funds);
- Loss of low SBD tax rate when accumulating passive income inside your corporation;
- Corporate structure and post-mortem planning when retaining funds inside your corporation;
- Need to recoup RDTOH inside the corporation.

Summary

Saving for future income needs requires you to plan ahead and weigh the options available to you. Saving inside your TFSA is not as clear-cut as saving inside your RRSP. The TFSA will outperform in many cases given sufficient time except when you decrease tax brackets upon removing the funds. 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.

Published and revised by: Estate & Financial Planning Services
Last revised: January 2023

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[1] 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*".

[2] For an analysis on retaining inside the corporation versus saving inside an RRSP see our companion article titled "*RRSPs for small business owners*".

[3] 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.

[4] 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.

[5] 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.

[6] 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.

[7] Dividends from your corporation are grossed-up (15% for non-eligible dividends and 38% for eligible dividends) and a combined federal and provincial/territorial 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.

[8] Assuming you were over 18 and resident in Canada as of 2009.

[9] We assume Andre has the cash flow to supplement any applicable payroll tax.

[10] 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.

[11] For the TFSA, we assume Andre withdraws the entire amount tax-free. 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.

[12] Throughout this analysis, we require more than 1% difference in the after-tax amount to Andre when compared to the original surplus to "outperform".

[13] 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.

[14] See our article titled "*RRSPs for small business owners*".

[15] The value accumulated in your TFSA can retain its tax-free status when you name a spouse as successor holder or beneficiary upon your death. However, you can only contribute to your TFSA while alive. You cannot contribute to them posthumously and your estate cannot make spousal contributions like with spousal RRSPs. As such, if you do not contribute to a TFSA during your lifetime, you lose the contribution room upon your death.

[16] TFSAs purchased from an insurance company that name a protected class beneficiary may benefit from creditor protection.