FINANCIAL POST

February 10, 2017

Small business owner dilemma: Invest in a RRSP, or do the investing through your corporation?

By Jamie Golombek

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While many people struggle with the decision of whether to max out their RRSP or TFSA (assuming you don't have the money to do both), incorporated small business owners, including incorporated professionals, have a more complex decision to make.

Should a business owner, who has excess funds from operations or her professional practice, withdraw those funds to make an RRSP (or, for that matter, a TFSA) contribution or should she invest inside the corporation instead?

For starters, to invest in an RRSP you must have sufficient contribution room. Your 2017 RRSP contribution room is calculated as 18 per cent of income earned in 2016 to a maximum of $26,010.

While salary that you receive from your corporation qualifies as earned income that creates RRSP room, dividends do not. As a result, if you want to invest in an RRSP, then you must pay yourself sufficient salary to generate the earned income necessary to generate contribution room.

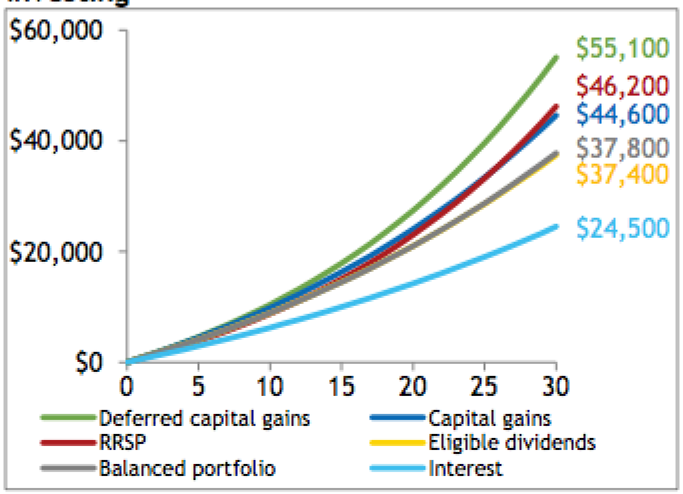
Alternatively, if you want to leave the funds in your corporation for investment, then you will take the money out later in the form of dividends.

If you choose to distribute corporate income as salary, you will pay personal tax on the salary income. Alternatively, if dividend compensation is chosen, the company pays corporate tax when income is earned and you pay personal tax when proceeds are distributed to you as a dividend.

In an ideal world, corporate and personal tax rates would be perfectly integrated, so that the total tax paid by a corporation and its shareholders would equal the tax paid by an individual, given the same amount of income. In reality this is rarely the case.

In recent years, there have been several changes to the taxation of corporations and their shareholders. Top personal tax rates have increased federally and in most provinces and corporate tax rates for small business income have decreased.

Figure 5 - Amount of after-tax investment income to shareholder with RRSP vs. Corporate investing



As a result, there is a very small "tax rate disadvantage" for business income in most provinces in 2017. This means that the combined tax paid by the corporation and shareholder will generally be marginally higher (less than 1 per cent) if business income is distributed as dividends rather than salary.

There is, however, a significant "tax deferral advantage" for business income in all provinces, such that a large amount of tax can be deferred by distributing income from the corporation in a later year.

For example, in 2017, there is a 0.6 per cent tax rate disadvantage (cost) with dividends in Alberta for business income that is eligible for the small business deduction (SBD income). If your Alberta corporation were to earn $100,000 of SBD income, the combined corporate and personal taxes would be only $600 (0.6 per cent x $100,000) higher if the $100,000 were distributed as dividends, rather than salary.

There is, however, a 35.5 per cent tax deferral advantage with dividends in Alberta. In other words, if your corporation were to earn $100,000 of small business income, the taxes payable currently (i.e. the corporate taxes) would be $35,500 (35.5 per cent x $100,000) lower if the $100,000 were distributed as dividends in a future year, rather than distributing salary in the current year.

The $35,500 deferred tax amount could be invested in the corporation until the future dividend payment, potentially earning enough investment income to offset the $600 tax cost.

For active business income that is not eligible for the small business deduction ("ABI"), there is a tax rate disadvantage (cost) with the payment of dividends in all provinces, ranging from 1.2 to 8.5 per cent.

Consequently, paying salary rather than dividends will result in lower overall taxes in all provinces. There is also a tax deferral advantage ranging from 20.4 to 27.0 per cent in all the provinces, which would result in a deferral of personal tax by foregoing salary currently and paying dividends in a later year.

The tax deferral advantage for SBD income and ABI allows the deferred tax amount to be invested until dividends are distributed in a later year; however, RRSPs also provide the ability to invest funds on a pre-tax basis and thus defer tax until withdrawal.

So the question is: would a business owner be better off receiving salary and investing in an RRSP, or having the corporation pay some tax and investing the after-tax corporate income inside the company instead?

We created models to look at this question over short and long periods of time using different types of investment returns and concluded that, given sufficient time, RRSP investing would outperform corporate investing when earnings come from interest income, eligible Canadian dividends, foreign income, annual realized capital gains or a typical, balanced portfolio.

Only in a situation where your portfolio earns 100 per cent capital gains and you are able to defer realization of 100 per cent of those gains for long periods of time would a business owner have been better off leaving excess funds in the corporation and forgoing an RRSP contribution.

Of course, there are other considerations[1] that need to be taken into account when making your own decision. For example, unlike paying dividends, if you pay yourself a salary, there are various payroll taxes associated with T4 income, such as mandatory Canada Pension Plan contributions, possible Employment Insurance premiums and potentially other provincial levies.

Being able to claim the $835,716 lifetime capital gains exemption on the sale of the shares of your corporation and the ability to split income with family members may also be considerations when deciding whether to pay salary or dividends.

Financial Post

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