RRSPs for small business owners

As a small business owner, your corporation may produce surplus above what you need for your business or personal lifestyle. 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. As seen below, maximizing your RRSPs makes sense for most business owners given a sufficient time horizon. This is even more true with the government's proposed changes in the 2024 Federal budget.

The potential tax deferral

Many small businesses in Canada benefit from low tax rates on active business income (the "general rate"). The combined federal and provincial/territorial general rate ranges from 23%-31% across Canada. There is a further reduction known as the small business deduction up to a threshold (the "small business rate"). The combined federal and provincial/territorial small business rates range from 9%-12.20% on the first $500,000. Saskatchewan has a hybrid 16% combined rate for income between $500,000 and $600,000.

On the other hand, your personal tax rates can exceed both corporate active business income tax rates in many cases. For ordinary income, the highest combined marginal tax rates average 50% across Canada in 2024. For dividends, the highest combined rates are approximately 28%-46% for eligible dividends and 37%-49% for non-eligible dividends. The lower personal tax rates on these dividends reflects the corporate tax already paid. Eligible dividends reflect the general rate and non-eligible dividends reflect the small business rate already paid by your corporation.

Upfront, the lower corporate tax rates suggest there is a tax deferral advantage for retaining funds inside your corporation. However, this does not automatically result in a deferral advantage. 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 when you withdraw the funds as the tax consequences on withdrawal differ. The goal is to have more after-tax to you personally when you choose to liquidate the investment and distribute proceeds. Key items that influence the analysis include:

- Your corporation's initial tax rate on active business income (general or small business rate).
- If you're in the same, lower, or higher tax bracket when you invest compared to when you liquidate the investment.
- The form of investment income generated (interest, dividends, capital gains, or deferred gains).
- Time horizon (the length of time the funds stay invested).

Investment vehicle characteristics

Below is a summary of the tax differences between removing and investing in your RRSP and retaining inside your corporation.

	RRSP	Corporate
Tax prior to investing	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 the general rate or small business rate (depending on total corporate income)
Tax on growth while invested	Tax deferred	Your corporation pays tax depending on the type of income: • Interest (46.67%-54.67%), taxable Canadian dividends (38.33%) and capital gains taxed as passive investment income. • As a result of the 2024 Federal Budget, tax on capital gains is 50% of the above rate on interest if realized prior to June 25, 2024 (23.34%-27.34%). It increases to 66 2/3% of the rate on interest if realized on or after June 25, 2024 (31.11%-36.45%). The non-taxable portion credits the notional capital dividend account (CDA). • Passive investment tax generates a credit to notional accounts known as the refundable dividend tax on hand (RDTOH). Your corporation recoups this when it pays taxable dividends to you as shareholder.
Tax inside the vehicle upon disposition	Tax deferred	Capital gains taxed as passive investment income inside the corporation when you liquidate or rebalance the investment (see above).
Personal tax on removal	Fully taxable as ordinary income	Your corporation can pay dividends to you as follows: • Tax-free capital dividends up to the CDA balance; and • Taxable eligible and non-eligible dividends. Dividends are grossed up (15% for non-eligible and 38% for eligible) on your personal tax return and a dividend tax credit applied. Paying taxable dividends allows your corporation to recoup RDTOH previously paid.
Contribution limits	18% of earned income up to $31,560 (2024)	N/A
Age limits	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

We'll analyse Andre's situation, a resident of Ontario at the highest tax bracket because of his $300,000 salary. His corporation is also resident in Ontario and has $10,000 before-tax surplus.

If Andre's corporation pays him additional 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. The result - Andre invests $10,000 in an RRSP.

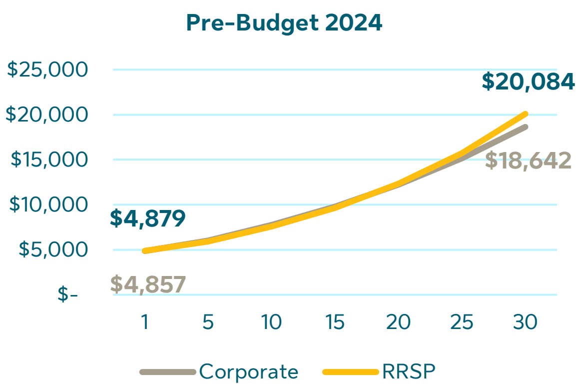
If Andre's corporation retains the surplus, the after-tax amount available to invest depends on the corporation's tax rate:

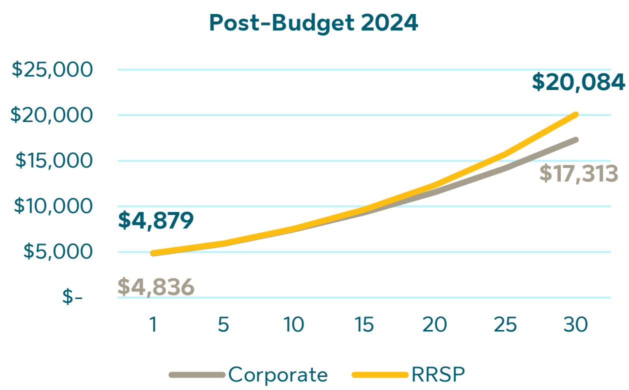
- **Small business rate**. The $10,000 profit has 12.2% corporate taxes, leaving $8,780 available to invest.
- **General rate**. The $10,000 profit has 26.5% corporate taxes leaving $7,350 available to invest.

The corporation then invests the after-tax amount subject to corporate investment tax rates as explained above. As a result of the 2024 Federal budget, the passive taxation inside your corporation is higher for capital gains realized on or after June 25, 2024. We'll look at pre-budget and post-budget situations below.

To compare apples to apples, Andre invests the available amount in the same investment either inside the corporation or RRSP. We'll review a hypothetical balanced portfolio earning 5% annually (equally divided between interest, dividends, capital gains and deferred gains). To make it a fair comparison, we need to look at the after-tax value of each option to Andre personally. So, we need to collapse the RRSP and remove the funds from the corporation.

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





When the corporation initially pays tax at the small business rate, the RRSP begins to outperform right from the beginning in both cases. You'll notice post-budget though, the amount available from the corporation is lower both to start and in later years. This reflects the increased tax for all corporate realized capital gains starting June 25, 2024. In both cases, although the RRSP starts higher, it takes time to produce a difference of more than 1%. However, prior to the proposed Budget 2024 changes, the RRSP took more time to create a difference of more than 1%.

Keep in mind, the lower your interest income inside your corporation, the better the corporate investment performs. However, your type of investment should meet your risk tolerance. We don't recommend choosing investments outside of your risk tolerance solely to produce a better tax result. Corporate class mutual funds can reduce interest-producing investments, although distributions on such investments may vary. Consult your financial advisor to review your risk tolerance and investment objectives prior to choosing your type of investment.

Now let's look at how the same investment performs across Canada at different tax rates. In all cases, we're looking for the time it takes the RRSP to outperform the corporate investment by 1%.

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're at the second federal tax bracket (around $56,000), third federal tax bracket (around $112,000), or the highest tax bracket (around $246,000+) during your lifetime.

Small business rates initially – years needed for RRSP to outperform corporate investment by 1%+

	Pre-Budget 2024			Post-Budget 2024		
	Second tax bracket	Third tax bracket	Highest tax bracket	Second tax bracket	Third tax bracket	Highest tax bracket
BC	5	11	22	3	5	11
AB	9	11	18	6	6	10
SK	12	14	20	9	10	12
MB	9	13	18	5	6	7
ON	6	13	21	4	7	11
QC	1	9	17	1	1	1
NB	10	14	21	6	8	12
NS	9	13	20	6	7	11
PEI	7	11	17	4	4	5
NL	8	11	19	5	6	10
YT	8	11	18	5	6	9
NWT	14	19	24	12	15	18
NU	4	5	10	2	3	4

When your corporation initially pays tax at small business rates, the RRSP generally provides more after-tax over time. As a result of the 2024 Budget, the time for an RRSP to outperform by more than 1% is much quicker.

If your corporation pays tax at the general rate

If your corporation initially pays tax at the higher general tax rate, it takes even less time for the RRSP to outperform pre- and post-Budget 2024. Only BC, NB, YT, and NWT need more than 1 year at the top marginal tax bracket. Even then, it only takes a maximum of 5 years. **So, investing in an RRSP makes sense for most if your corporation pays tax at the general rate.**

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. 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. **So, RRSPs make even more sense if you expect to drop tax brackets in the future.**

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. As you increase tax brackets, the time needed for the RRSP to outperform the corporate investment increases. However, the time shown on the "highest tax bracket" column is the upper limit needed for that form of investment. **So, given sufficient time, investing in an RRSP likely makes sense.**

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 whereas RRSPs benefit from Federal bankruptcy protection and general creditor protection in some provinces).
- Eligible pension income for registered accounts compared to tax on split income rules for corporate funds.
- Flexibility to determine income (RRSPs have forced income after age 71).
- Loss of low small business rate when accumulating passive income inside your corporation.
- Corporate structure and complexity and cost of post-mortem planning when retaining funds inside corporation.
- Need to recoup RDTOH built up 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. The proposed changes in the 2024 Federal Budget make corporate investing less attractive compared to an RRSP. Use the above as a guideline to make an informed decision particular to your stated goals and objectives.