ACME INC.

Rethinking RRSPs

Business owners tend to pay themselves enough each year to ensure they can maximize their RRSP contributions. Yet given the tax deferral opportunities available to small businesses, **Jamie Golombek** concludes that leaving funds in the company may make more sense than taking a salary

If you're an incorporated small business owner, chances are you've probably been advised at one time or another to pay yourself at least enough salary from your corporation to allow you to contribute the maximum amount to an RRSP. This is because the ability to contribute to an RRSP is dependent on receiving "earned income" in the prior year. Earned income includes salary and bonuses but does not include dividends. Subject to an annual cap, the annual RRSP contribution limit is calculated as 18 per cent of the prior year's earned income. For example, in 2010, you would have to receive a salary of at least $124,722 to be able to contribute the maximum amount to an RRSP ($22,450) for 2011.

There are potentially two flaws with this reasoning, at least for Canadian-controlled private corporations (CCPC) with taxable income subject to the preferred corporate small business tax rate[1]. First, if you need the cash, depending on your province of residence, you may actually pay more tax on the funds withdrawn as a salary than if the same funds were taxed to the corporation and then withdrawn as dividends. Second, if you don't need the cash, you give up a significant tax deferral by withdrawing the funds as a salary to be taxed immediately rather than leaving the cash in the corporation to be taxed at a much lower small business corporate tax rate.

These two points are based on what is commonly known as the "theory of integration."

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[1] The corporate small business tax rate is a special, low rate of tax available to Canadian-controlled private corporations on active business income (not investment income) subject to the annual small business limit, which is $500,000 federally and $400,000 in most provinces other than Manitoba and Nova Scotia.

THE THEORY OF INTEGRATION

The Canadian income tax system is designed in such a way that an individual should be indifferent between earning income personally or through a private corporation. In other words, an individual should pay the same amount of tax on active business income whether that income was earned personally or earned (and taxed) through a corporation and then paid out as a dividend to be taxed in the shareholder's hands. This is known as the theory of integration.

Under perfect integration, it should make no difference for a business owner if she takes a salary or dividends because she will pay the same amount of tax either way. In the case of a salary, it is tax deductible to the corporation — thus reducing its taxable income — but is instead taxed in the hands of the business owner at the appropriate personal rate. In the case of dividends, corporate income tax is paid on the income, and the after-tax amount is paid out as a dividend and taxed in the business owner's hands at the preferred dividend rate. Under perfect integration, the total personal income tax paid by a business owner on a salary should be equal to the combined personal and corporate income tax paid where the remuneration is taken in the form of a dividend.

Perfect integration is achieved when the combined federal-provincial personal tax rate is 43.5 per cent and the combined corporate tax rate is 20 per cent (12 per cent federal and 8 per cent provincial). Chart 1 below illustrates perfect theoretical integration on $1,000 of income. As you can see, the tax paid on $1,000 of personally earned income ($435) is equal to the sum of the tax paid by a corporation ($200) on $1,000 of corporately earned income and the tax paid at the shareholder level ($235) when the $800 net corporate after-tax income is paid out as a dividend and taxed in the individual shareholder's hands.

CHART 1: Theoretical Integration of Income Earned Personally Versus Inside a Corporation

Earned directly by individual	
Personal income	$1,000
Income tax	(435)
Net Cash	$ 565
Earned through a corporation	
Corporate income	$1,000
Small business corporate tax	(200)
Net cash retained after tax	$ 800
Dividend payable	$ 800
Net personal tax on dividend	(235)
Net cash to business owner	$ 565
Conclusion	
Cash – corporation	$ 565
Cash – personal	(565)
Net advantage	$ 565
Percentage	0.0%

THE TAX RATE ADVANTAGE

The reality of "perfect integration," however, is that we don't live in a perfect world and that perfect integration doesn't exist. In fact, the actual tax rates in each province differ from the tax rates upon which the theory of integration is based. The absence of perfect integration means that absolute tax savings can be realized by having income taxed inside the corporation at the small business tax rate and then paid out as a dividend, rather than having the corporation pay a tax-deductible salary to be taxed in the hands of the individual.

There are two reasons for the tax savings. First, the actual combined top marginal personal tax rates in all provinces other than Alberta and New Brunswick are higher than the theoretical perfect rate of 43.5 per cent. In fact, provinces such as Ontario, Nova Scotia and Prince Edward Island have significantly higher marginal personal tax rates, which include surtaxes not considered in the theoretical rate. Second, in all provinces, the combined federal and provincial small business income tax rate is below the theoretical 20 per cent perfect integration rate. (See Chart 2 below.)

CHART 2: Comparative Combined Federal and Provincial Tax Rates

	Personal top marginal rates	Small business rates
Theoretical	43.50%	20.00%
British Columbia	43.70%	13.50%
Alberta	39.00%	14.00%
Saskatchewan	44.00%	15.50%
Manitoba	46.40%	11.92%
Ontario	46.41%	16.00%
Quebec	48.22%	19.00%
New Brunswick	43.30%	16.00%
Nova Scotia	50.00%	16.00%
Prince Edward Island	47.37%	12.28%
Newfoundland and Labrador	43.40%	16.00%

The result of this imperfect integration is that in all provinces except Quebec, the tax a business owner pays on income earned personally is actually higher than the sum of the corporate small business tax and the personal tax paid by the shareholder on income earned through a corporation and paid out as dividends. As Chart 3 shows, the tax savings ranges from a negligible 0.3 per cent in Prince Edward Island to a high of 3.6 per cent in Nova Scotia.

CHART 3: Tax Rate Advantage of Paying Dividends over Salary

Province	Tax rate savings of dividends
British Columbia	1.0%
Alberta	1.2%
Saskatchewan	2.5%
Manitoba	0.8%
Ontario	3.1%
Quebec	(0.2%)
New Brunswick	1.4%
Nova Scotia	3.6%
Prince Edward Island	0.3%
Newfoundland and Labrador	1.1%

THE TAX DEFERRAL ADVANTAGE

The tax rate advantage, however, is only half the story if you don't personally need the cash. Where you have other sources of cash to fund your living expenses, for example, it may not be necessary to extract any funds from the corporation at all. In this case, by choosing to have the business income taxed in the corporation at the preferential small business rate and reinvested inside the company — instead of paying that income out as a salary to be taxed immediately at a much higher personal tax rate — the business owner can benefit from a generous and potentially long-term tax deferral.

Keep in mind, however, that this is only a tax deferral as the after-tax corporate income will be taxed a second time in the hands of the shareholder when it is paid out as a dividend. Naturally, the value of this deferral will depend on the length of time the funds can be left in the corporation as well as the rate of return earned on the funds.

As outlined in Chart 4, this tax deferral ranges from a low of 25 per cent in Alberta to a high of over 35 per cent in Prince Edward Island.

CHART 4: Tax Deferral Opportunity of Funds Left in the Corporation

Province	Tax deferral advantage
British Columbia	30.2%
Alberta	25.0%
Saskatchewan	28.5%
Manitoba	34.5%
Ontario	30.4%
Quebec	29.2%
New Brunswick	27.3%
Nova Scotia	34.0%
Prince Edward Island	35.1%
Newfoundland and Labrador	27.4%

PAYROLL TAXES ON SALARIES

The other downside to paying a salary is the various payroll taxes associated with T4 income, such as Canada Pension Plan premiums, employment insurance premiums and other provincial levies.

Canada Pension Plan (CPP) premiums

Business owners who are paid a salary must contribute to the CPP, which provides certain benefits to a contributor and his or her family on retirement, disability or death. For example, in 2010, the CPP pays a maximum retirement pension of $934 per month, which is fully indexed to inflation.

This pension, however, comes at a price since both the employer and employee must contribute 4.95 per cent of salary paid, up to the yearly maximum pensionable earnings of $47,200, with the first $3,500 exempted. In 2010, this works out to a maximum CPP premium of $2,163 for *both* the employee *and* the employer, or a total contribution of $4,326 to fund the pension.

Paying enough salary to maximize CPP entitlements is often touted as one of the benefits of paying a salary over dividends (which are not considered pensionable earnings for the purpose of earning CPP entitlements). It's questionable, though, whether over the course of a 40-year career the premium savings could not be independently invested in a diversified portfolio to ultimately produce a larger pension income.

Employment insurance (EI) premiums

While EI premiums are another payroll tax, this is generally not a concern if the business owner owns more than 40 per cent of

the voting shares of the corporation and thus is exempt from the payment of EI premiums on salary remuneration.

For ownership of 40 per cent or less, however, the 2010 total combined cost of EI premiums for an employee and employer reaches a maximum of $1,794 once insurable earnings hit $43,200, adding yet another cost to paying a salary instead of dividends, which are not subject to EI premiums.

Other payroll taxes

Some provinces levy an additional payroll tax that can also increase the cost of salary remuneration. In Ontario, for example, corporations that pay total remuneration to all employees exceeding the $400,000 exemption must pay a 1.95 per cent Ontario Employer Health Tax (EHT), which is not payable on dividend remuneration.

RRSPS: RETHINKING CONVENTIONAL WISDOM

Small business owners may actually be better off paying themselves enough dividends each year to fund current consumption and retaining any surplus funds inside the corporation, where they would be invested in a diversified portfolio.

This strategy generally makes sense where pre-salary/bonus corporate taxable income is subject to the small business tax rate. The basic premise is that the amount the owner-manager would have contributed to an RRSP is instead left inside the company and invested in the same manner as an RRSP. At retirement, instead of withdrawing funds from an RRSP or a registered retirement income fund (RRIF) to live on, the business owner would sell corporately held investments and extract the after-tax proceeds as a non-eligible dividend.

Taxation of investment income in a private corporation

When surplus funds are invested in a diversified portfolio inside the corporation, the invested capital may generate interest income, Canadian dividends and/or capital gains.

Interest income is fully taxed each year, whereas Canadian dividends from portfolio investments are taxed in the year they are received. Only 50 per cent of capital gains are taxed and only when they are realized. The after-tax corporate investment income (including the 50 per cent taxable portion of capital gains) can then be paid to the business owner as a taxable dividend and taxed at his or her personal dividend rate. The 50 per cent non-taxable portion of realized capital gains can be paid out to the Canadian resident business owner as a tax-free capital dividend.

It's important to note that interest income, dividend income and capital gains are not taxed at the favourable small business tax rate; rather, they are taxed at much higher corporate tax rates. Fortunately, a portion of the corporate tax paid on this income is refundable to the corporation when it pays out a taxable dividend to the shareholder.

Consequently, in most provinces, the total tax paid on investment income earned (and capital gains realized) in a private corporation is only slightly higher than if the investment income was

Depending on your province of residence, you may actually pay more tax on the funds withdrawn as a salary than if the same funds were taxed to the corporation and then withdrawn as dividends.

earned (and capital gains were realized) by the small business owner personally. Again, this is the theory of integration at work.

When comparing investing in a corporation with investing in the tax-sheltered environment of an RRSP, one would have thought that the RRSP would significantly outperform the unsheltered environment because income tax is not paid immediately on investment returns, leaving more capital to be reinvested. However, it is important to remember that one loses the traditional advantages associated with earning capital gains (taxable at 50 per cent) or Canadian portfolio dividends (eligible for the dividend tax credit) when this type of investment income is earned inside an RRSP. When earned inside a corporation, these tax advantages are preserved.

Life insurance as investment income shelter

To further maximize the benefit of retained corporate investment income, a business owner may consider using corporate-owned life insurance to shelter investment income from tax. Corporate-retained earnings invested in an insurance contract could generate enhanced returns. Investments that would have been exposed to tax, in particular highly taxed fixed income investments, can accumulate within the policy on a tax-free basis. Upon the death of the shareholder, it may be possible to extract some or all of the value of the life insurance proceeds from the company through tax-free capital dividends. Further, the insurance contract could also provide a form of creditor protection that is not available through conventional investments.

OTHER CONSIDERATIONS

In determining whether a surplus investment strategy — rather than a salary/RRSP maximization approach — is appropriate for a business owner, there are other factors to consider. These include eligibility for the lifetime capital gains exemption and creditor protection.

Lifetime capital gains exemption (LCGE)

Another consideration when making investments through a small business corporation is to ensure that the investments do not inadvertently disqualify the owner from claiming the $750,000 LCGE upon a sale of qualified small business corporation (QSBC) shares (or, ultimately, upon a deemed disposition at death).

Simply stated, QSBC shares are shares of a Canadian-controlled private corporation in which "all or substantially all" (90 per cent or more) of the value of the corporation's assets is used in an active business at the date of sale (or death), or consist of debt or shares of other SBCs. In addition, either you or someone related to you has to have owned the shares for at least two years

prior to their disposition, and during that two-year period more than 50 per cent of the corporation's assets had to have been used in an active business.

Investing surplus cash in the corporation may jeopardize its QSBC status because of the accumulation of investments that do not meet the asset tests outlined above. It should be possible to restore a corporation's QSBC status by extracting non-active assets through a process known as "purification."

There are a number of ways to purify the company — some are simple, while others are more complex. Simple strategies can include regularly distributing non-active assets (as dividends, capital dividends or return of capital); paying down debts with non-active assets; purchasing additional active business assets or pre-paying business expenses; or paying a retiring allowance. More complex strategies often involve paying tax-free inter-corporate dividends from the operating company (the active business) to a connected company, or transferring non-active assets or assets with accrued gains to a sister company on a tax-free basis, thus purifying the operating company.

Creditor protection

In addition to the significant deferral of tax on earnings and gains realized within an RRSP, RRSPs can also provide business owners with an effective method of creditor protection. The federal bankruptcy laws were amended a number of years ago to provide that RRSPs and RRIFs are protected from creditors upon bankruptcy, excluding contributions made within the final 12 months prior to bankruptcy.

Investments held inside a corporation are without the benefit of creditor protection and therefore shouldn't be held in an operating company, but rather in a holding company or sister company, as discussed in the purification strategy above. F

By choosing to have the business income taxed in the corporation at the preferential small business rate and reinvested inside the company — instead of paying that income out as a salary to be taxed immediately at a much higher personal tax rate — the business owner can benefit from a generous and potentially long-term tax deferral.

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