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TFSAs for Business Owners… A Smart Choice

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Incorporated business owners can choose to invest surplus funds within their corporation or to withdraw these funds and invest personally. A Tax Free Savings Account (TFSA) provides a great opportunity to earn tax-free investment income, especially now that the annual TFSA dollar limit stands at $10,000 for 2015. By investing in a TFSA, rather than leaving surplus funds in the corporation for investing, business owners will generally end up with more after-tax cash at the end of the day, especially when the time horizon is significant.

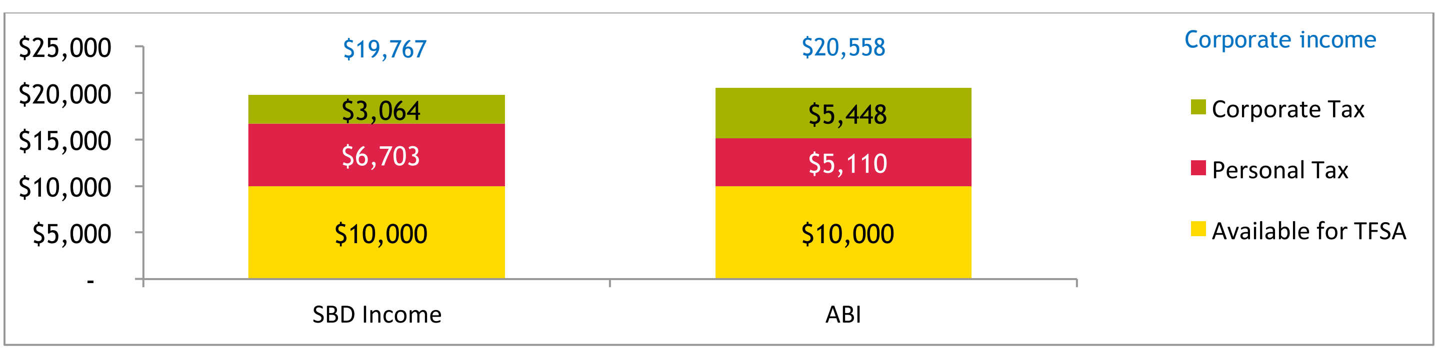
In our report Bye Bye Bonus,[1] we showed that it may be beneficial to leave funds in your corporation for investment, rather than withdrawing the funds and investing personally, due to a significant tax deferral advantage. The amount that was deferred could be used as investment capital in the corporation, which could then generate additional investment income. In that report, however, it was assumed that personal funds, once withdrawn from the corporation, would be invested in a non-registered account, leaving investment income exposed to taxes.

What if personal funds were, instead, invested in a TFSA? This report will show that, instead of leaving funds in your corporation for investment, using funds withdrawn from your corporation to maximize your TFSA may be a smart choice.

USING CORPORATE BUSINESS INCOME TO FUND A TFSA CONTRIBUTION

TFSA contributions can only be made personally and not by your corporation.[2] As a result, to make a TFSA contribution, you must first withdraw the funds from your corporation. Perhaps the starting point, then, is to determine how much business income would you need to earn in your corporation in order to have enough after-tax funds to personally contribute $10,000 to your TFSA. The answer is affected by corporate and personal tax rates, which vary by province, and whether income is eligible for the small business deduction (SBD Income)[3] or is other active business income (ABI) that is not eligible for the small business deduction.[4]

Figure 1: Corporate income required to yield $10,000 for TFSA contribution in Ontario (2015)



For example, Figure 1 shows that if your corporation were to earn $19,767 of SBD Income in Ontario in 2015, after paying corporate tax of $3,064 there would be $16,703 left to be paid to you as a non-eligible dividend.[5] Personal tax of $6,703 would be payable on the dividend leaving $10,000 in your hands for you to make the TFSA contribution.

Alternatively, if your corporation were to earn $20,558 of ABI in Ontario in 2015, corporate tax would amount to $5,448 (which is higher than for SBD Income) leaving $15,110 to be paid as an eligible dividend. After paying personal tax of $5,110 (which is lower than for a non-eligible dividend), you would net $10,000 for your TFSA contribution.

Since provincial tax rates vary, Figure 2 shows how much business income (either SBD Income or ABI) you would need to earn in your corporation, as well as the amount of dividends that would need to be distributed, so that you would be able to contribute $10,000 to your TFSA after corporate and personal taxes in each province in 2015.

Figure 2: Business income & dividends needed to make a $10,000 TFSA contribution (2015 rates)

	SBD Income		ABI	
	SBD Income	Non-eligible dividend	ABI	Eligible dividend
AB	$16,812	$14,459	$17,112	$12,661
BC	$18,643	$16,126	$18,947	$14,020
MB	$18,972	$16,885	$20,222	$14,762
NB	$22,153	$18,830	$22,193	$16,201
NL	$17,422	$14,983	$20,580	$14,612
NS	$20,004	$17,203	$22,665	$15,639
ON	$19,767	$16,703	$20,558	$15,110
PE	$19,320	$16,325	$20,325	$14,024
QU	$20,500	$16,605	$21,119	$15,438
SK	$17,658	$15,363	$18,218	$13,299

EXAMPLE OF INVESTING IN A TFSA OR CORPORATION USING SBD INCOME

Let's look at an example that compares using SBD Income in Ontario in 2015 to invest either within a corporation or via a TFSA.

Suppose your corporation earned $19,767 of SBD Income. In Figure 1, we saw that after paying corporate tax of $3,064 there would be $16,703 remaining in the corporation. Your choices for this after-tax SBD Income include:

1) **Investing in a TFSA:** You may withdraw $16,703 from your corporation in 2015 as a non-eligible dividend, pay personal tax of $6,703 and have $10,000 in your hands, which could be invested in a TFSA.

2) **Investing in your corporation:** You may leave the $16,703 in your corporation in 2015, which could be used by the corporation to invest. When the $16,703 is ultimately distributed to you as a non-eligible dividend in some future year, you would still ultimately pay personal tax of $6,703 (assuming tax rates do not change) and have $10,000 in your hands.

We can see that whether you invest via a TFSA or through your corporation, there is no difference in the amount of the original $19,767 of SBD Income that ultimately reaches your hands, after corporate and personal taxes are paid. You would always receive $10,000, again, assuming tax rates do not change.

There are, however, two main differences with investing corporately compared to via a TFSA.

1. The corporate tax deferral advantage

With corporate investing, there is a "tax deferral advantage," since $6,703 of personal tax is deferred until the ultimate distribution of after-tax SBD Income in a future year. As a result of the tax deferral, you would originally have more to invest in your corporation ($16,703) than your TFSA ($10,000).

Since your corporation would have a higher amount of investment capital, if corporate investments and a TFSA earn the same pre-tax rate of return, your corporation could generate more investment income than a TFSA.

2. Taxes on investment income

Corporate investment income is taxable while TFSA income is completely tax-free. In Figures 4 through 7 below, we will demonstrate that the (annual) taxes on corporate investment income can significantly erode the benefit of the tax deferral advantage over time.

Let's continue with our Ontario example, assuming a 5% rate of return on investments,[6] to illustrate how the tax deferral and taxes would affect the amount available with corporate investments in the short and long term, compared to a TFSA.

Investing in a TFSA – All types of income

If you invested $10,000 in a TFSA at a 5% rate of return, after one year, you would have $500 ($10,000 x 5%) of investment income. For all types of income, a TFSA is completely tax-free, so the full $500 would be available to you.

Figure 3: Cumulative net investment income[7] if $10,000 is invested in a TFSA, 5% rate of return

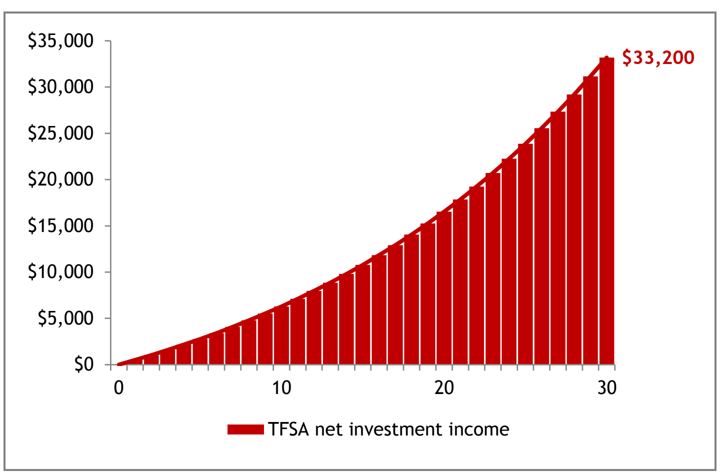


Figure 3 shows that if you were to reinvest income within a TFSA, after 30 years you would have accumulated total income of $33,200 (in addition to the original capital of $10,000). With no federal or provincial taxes, the total net investment income in a TFSA will always be $33,200 after 30 years for each type of income and in every province. You might say that TFSAs are truly an "equal-opportunity" investment.

Investing in your corporation

By leaving after-tax SBD Income in the corporation, you would have $16,703 of capital to invest, assuming 2015 Ontario tax rates. At a 5% rate of return, the corporate investments would yield $835 of income in the first year, regardless of the type of income. This is 67% more than the $500 of TFSA investment income because 67% more capital is available with a corporation ($16,703) than with a TFSA ($10,000).

The problem is that a corporation must pay tax on its investment income, which reduces the amount available for reinvestment and, thus, the total amount of investment income that may be accumulated in the corporation throughout the year(s). At the end of the year(s), assuming that all the remaining after-tax investment income is distributed as a dividend, you must also pay personal tax on the dividend. The amount that you receive after all corporate and personal taxes have been paid is your "net investment income" from the corporate investments.

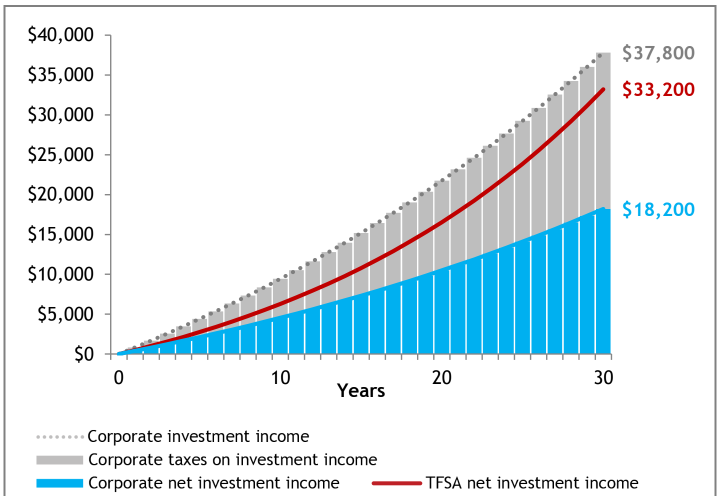
Corporate and personal taxes vary for each type of income. A full description of taxation of corporate investment income is provided in our report, *In Good Company*.[8] Consequently, the net investment income ultimately available through corporate investing varies with the type and taxation of investment income that is earned.

Interest

Using 2015 tax rates in Ontario, if your corporation earned $835 (16,703 X 5%) of interest income, after paying corporate tax on the income and personal tax on the non-eligible dividend, you would be left with $403 of net investment income.[9] This is less than the $500 available with a TFSA, as determined above.

Over 30 years, corporate taxes would erode the amount that may be reinvested, impacting total investment income that is accumulated in the corporation. Figure 4 shows that after 30 years, the corporation would have generated total pre-tax interest income of $37,800 (about 14% more than the $33,200 available with a TFSA). After personal taxes upon final withdrawal, however, net investment income would amount to just $18,200 (about 45% less than the $33,200 in a TFSA).

Figure 4: Cumulative net investment income[10] and taxes if $16,703 is invested in a corporation vs. $10,000 in a TFSA (5%, interest income, Ontario 2015 tax rates)



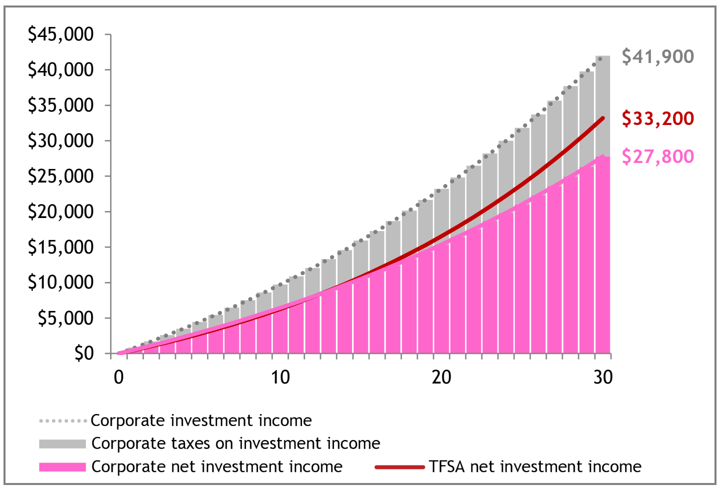
In summary, using a 5% rate, if interest is earned in Ontario using 2015 tax rates, investing in a TFSA is always a better option than corporate investing over a 30 year time period.

Canadian eligible dividends

Let's say your corporation invests in Canadian stocks that earn $835 (16,703 X 5%) of eligible dividends. After corporate and personal taxes are paid, the net investment income would total $553,[11] which is more than the $500 that would be available in a TFSA after one year.

Figure 5 shows that corporate taxes on eligible dividends would impact total investment income to a lesser degree than with interest income.[12] After 30 years, the corporation would have generated total pre-tax eligible dividend income of $41,900 (about 26% more than the $33,200 in a TFSA); however, after corporate and personal taxes, net investment income would amount to $27,800 (about 16% less than the $33,200 in a TFSA).

Figure 5: Cumulative net investment income[13] and taxes if $16,703 is invested in a corporation vs. $10,000 in a TFSA (5%, eligible dividends, Ontario 2015 tax rates)



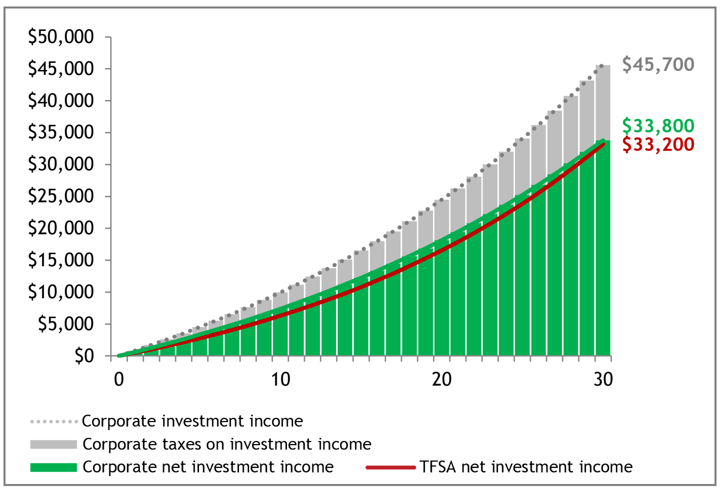
As we can see, when eligible dividend income is earned, using 2015 tax rates in Ontario, net investment income would initially be slightly higher with corporate investments than with a TFSA. In the long run, however, starting after about 10 years in our example, the TFSA would outperform corporate investments. Note that the crossover point is dependent on the rate of return achieved on the underlying investment.

Capital gains realized annually

Using 2015 tax rates in Ontario, if your corporation realized $835 (16,703 X 5%) of capital gains in the first year, corporate and personal taxes would total $218.[14] The net investment income of $619 with a corporation is more than the $500 with a TFSA after one year.

Figure 6 shows total pre-tax capital gains with a corporation would be higher than with a TFSA, ending at $45,700 after 30 years (about 38% more than the $33,200 in a TFSA). After corporate and personal taxes, however, corporate investing yields only nominally more than in a TFSA. After 30 years, net investment income with a corporation would be $33,800 (compared to $33,200 in a TFSA).

Figure 6: Cumulative net investment income[15] and taxes if $16,703 is invested in a corporation vs. $10,000 in a TFSA (5%, annual capital gains, Ontario 2015 tax rates)



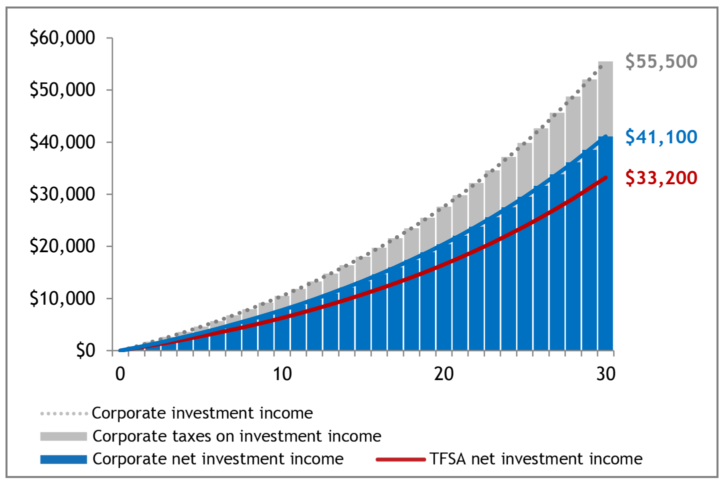
When capital gains are realized annually, we can see that over 30 years corporate investing yields about the same amount of net investment income than a TFSA. (Over a longer term, the TFSA outperformed corporate investments. Again, the crossover point is dependent on the rate of return achieved on the underlying investment.)

Deferred capital gains

When capital gains are realized annually, corporate tax must also be paid annually and decreases the amount of after-tax investment income that is available in the corporation for reinvestment. In contrast, when capital gains are deferred, corporate tax only becomes payable when after-tax corporate investment income is distributed as a dividend at the end of the year(s).

At a 5% rate of return, capital gains would total $835 (16,703 X 5%) in the first year. If income was distributed at the end of Year 1, the capital gain would be realized and the result would be the same as with annual capital gains: taxes would total $218, netting $619 with corporate investing.

Figure 7: Cumulative net investment income[16] and taxes if $16,703 is invested in a corporation vs. $10,000 in a TFSA (5%, deferred capital gains, Ontario 2015 tax rates)



If income was not distributed at the end of the first year, and the capital gain was not realized, the full $835 could be reinvested in the corporation. Figure 7 shows that over time, without annual corporate taxes, the corporation would earn a substantially higher amount of total capital gains. After 30 years, total capital gains with a corporation would be $55,500 (67% more than the $33,200 in a TFSA[17]) and net investment income would be $41,100 (24% higher than a TFSA).

As we can see, if deferred capital gains are earned in Ontario, corporate investing always outperforms a TFSA.

MORE ABOUT THE KEY DIFFERENCES BETWEEN CORPORATE INVESTMENTS AND A TFSA

The tax deferral advantage

We saw in the examples above that the high tax deferral advantage on SBD Income makes it possible to invest significantly more capital in a corporation than in a TFSA. In 2015, the tax deferral advantage on SBD Income in the provinces ranges from 29% (in Newfoundland and Labrador) to 40% (in New Brunswick).

The tax deferral advantage for ABI, on the other hand, is significantly lower in 2015, ranging among the provinces from 14% (in Alberta and Newfoundland and Labrador) to 28% (in New Brunswick). Due to the lower tax deferral with ABI than SBD Income, it is less likely corporate investments will outperform a TFSA when the corporation initially earns ABI than when the corporation initially earns SBD Income.

Taxes on investment income

With more investment capital in a corporation, a higher rate of return over a longer time period increases the benefits from reinvesting corporate investment income. Higher taxes are more likely to offset this benefit, while lower taxes are less likely to offset this benefit.

We saw in the examples above that tax rates are highest with interest. Further analysis for all the provinces showed that corporate investing never outperformed the TFSA with interest income, regardless of the rate of return or time horizon.

Conversely, tax rates are lowest with capital gains and, for deferred capital gains, the taxes are deferred until income is distributed from the corporation. Further analysis for all the provinces showed that corporate investing always outperformed the TFSA with deferred capital gains, regardless of the rate of return or time horizon.

While tax rates are also favourable for eligible dividends and annual capital gains, corporate taxes are payable annually. Further analysis for all the provinces showed that, despite the preferable rates, annual taxes were still likely to erode the corporate tax deferral benefit over time. For eligible dividends and capital gains, corporate investments are less likely to outperform a TFSA as the rate of return or time horizon increases.

Finally, provincial tax rates on investment income also vary. In provinces with high tax rates, corporate investments are less likely to outperform a TFSA than in provinces with low tax rates.

CONCLUSION

As you can see, many variables may affect your decision to invest in a corporation or TFSA but here is the bottom line: Over time, corporate investments will likely leave you with less in your pocket than a TFSA, especially when corporate business income does not benefit from the small business deduction or investment income is highly-taxed. For deferred capital gains, corporate investments always yield a greater amount than a TFSA and, so, are the exception to this rule-of-thumb; however, few investors would be likely to defer all capital gains.

If you are a business owner who wants to get the most from your investments over the long run and your portfolio earns a combination of interest, eligible dividends and capital gains, you should probably consider withdrawing sufficient corporate funds to maximize your TFSA contributions, rather than leaving the funds inside the corporation for investment.

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1 The report *Bye Bye Bonus* is available online at https://www.cibc.com/ca/pdf/jg-dividends-bonus-en.pdf

2 Throughout this report, it is assumed that you are the shareholder and that you pay personal tax at the highest combined federal/provincial marginal tax rate.

3 The small business deduction is available to Canadian controlled private corporations (CCPCs) that earn active business income subject to the annual small business limit, which in 2015 is $500,000 federally and in all provinces other than in Manitoba, where it is $425,000, and Nova Scotia, where it is $350,000. Effective January 1st, 2016, the Manitoba small-business limit will increase from $425,000 to $450,000.

4 The amount of business income that is required would also differ if corporate funds were distributed as salary/bonus, rather than dividends. In fact, it may be advantageous to distribute corporate funds as salary/bonus rather than dividends in 2015 due to the tax rate disadvantage that exists in many provinces in 2015 (as described in our report Bye Bye Bonus). Since salary distributions may also necessitate CPP and EI contributions, to simplify the analysis and keep calculations consistent, it is assumed that corporate funds are distributed as dividends.

5 Eligible dividends are generally paid out of corporate income that has been taxed at a high rate, such as ABI, while non-eligible dividends are dividends paid out of a corporation that earned either SBD income (see endnote 3) or investment income such as interest or taxable capital gains. Generally, dividends from public Canadian companies and mutual funds are eligible dividends.

6 The rates of return used in the examples in this report are for illustrative purposes only. A return of 5%, while unrealistic for fixed income returns today, was used to be able to see the impact of earning different types of income (interest, dividends and capital gains) within a TFSA or corporation, using a consistent rate.

7 Cumulative net investment income does not include the after-tax SBD Income, which provided the original $10,000 of capital for TFSA investments.

8 The report *In Good Company* is available online at https://www.cibc.com/ca/pdf/small-business/in-good-company-en.pdf.

9 Using Ontario 2015 tax rates, $835 of corporately-earned interest income is taxed at 46.17%, of which 26.67% is refundable, thus netting $672 {$835 X [1 – (0.4617 – 0.2667)]} that can be paid out as a non-eligible dividend. After personal tax at 40.13%, the after-tax cash available is $403 [$672 X (1 – 0.4013)].

10 Cumulative net investment income does not include the after-tax SBD Income, which provides the original $16,703 of capital for corporate investments and yields $10,000 of net investment income.

11 In Ontario in 2015, if a corporation earns $835 of eligible dividends, corporate Part IV tax is $278 ($835 x 33.3%). Part IV tax is added to the RDTOH account and may be refunded when a taxable dividend is paid. Since Part IV tax is fully refundable, $835 may be distributed as eligible dividends. Personal tax on the dividends would amount to $282 ($835 x 33.82%) leaving net investment income of $553 ($835 - $282).

12 Corporate Part IV tax of 33.3% on eligible dividends is less than corporate tax of 46.17% on interest.

13 See endnote 10.

14 Using Ontario 2015 tax rates, 50% of the $835 of corporately-realized capital gain comes out tax-free as a $418 capital dividend. The other 50% is taxed at 46.17%, of which 26.67% is refundable, thus netting $336 {$835 X 50% [1 – (0.4617 – 0.2667)]} that can be paid out as a non-eligible dividend. After personal tax at 40.13%, the after-tax cash available is $201 [$336 X (1 – 0.4013)] + $418 of capital dividend, for a total after-tax cash of $619.

15 See endnote 10.

16 See endnote 10.

17 Deferred capital gains are not taxed annually in a TFSA or in a corporation (corporate tax only applies in the year that any after-tax investment income is distributed as a dividend). Since the initial investment capital with corporate investments ($16,703) is 67% higher than with a TFSA ($10,000), the corporate capital gains are also 67% higher.

Disclaimer:

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