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Rethinking RRSPs for Business Owners: Why Taking a Salary May Not Make Sense

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Abstract

Traditionally, many Canadian small business owners have been advised to pay themselves enough salary and bonus to ensure they can maximize their RRSP contributions each year regardless of whether they actually need the cash personally. This report challenges this age old maxim. First, to the extent that the business owner needs cash personally, it may be preferable to extract the cash from the corporation in the form of dividends and forgo the RRSP contribution. Second, if the business owner does not need to withdraw the cash immediately, a significant tax deferral can be achieved by simply leaving the money inside the corporation and investing the funds instead of paying them out as a salary to be taxed and investing the cash in RRSPs and non-registered personal accounts.

Introduction

If you're an incorporated small business owner, chances are you've probably been advised at one time or other to pay yourself at least enough salary from your corporation to allow you to contribute the maximum amount to an RRSP.

That's because the ability to contribute to an RRSP is dependent upon receiving "earned income" in the prior year. Earned income includes salaries and bonuses but does not include dividends. Subject to an annual cap, the annual RRSP contribution limit is calculated as 18% 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rate.² First, if you need the cash, depending on your province of residence, you may actually pay more tax on the funds withdrawn as a salary than if the same funds were taxed to the corporation and then withdrawn as dividends.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 instead of simply leaving the cash in the corporation to be taxed at a much lower small business corporate tax rate.

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

¹ The author would like to thank Deloitte & Touche LLP's Private Company Services Group for their assistance in designing the model used to test the theory as well as for their invaluable comments provided during various drafts of this report.

² 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 in most provinces, other than Manitoba and Nova Scotia, where it is \$400,000.

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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 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, a business owner should be indifferent between taking a salary or dividends because the same amount of tax will be paid either way. In the case of a salary, it is tax deductible to the corporation reducing its taxable income and 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% and the combined corporate tax rate is 20%. Chart 1 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 exactly 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.

The Tax Rate Advantage

The reality is, however, that we don't live in a perfect world and perfect integration does not exist. In particular, the actual tax rates in all provinces are quite different than 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 the provinces other than Alberta, New Brunswick and Newfoundland and Labrador are higher than the theoretical "perfect" rate of 43.5%. In fact, provinces such as Ontario, Nova Scotia and PEI have significantly higher marginal personal tax rates, which include surtaxes that are not contemplated in the "theoretical" rate. Second, in all of the provinces, the combined federal and provincial small business income tax rate is below the theoretical 20% perfect integration rate (Chart 2).

Chart 1

Theoretical Integration of Income Earned Personally vs. 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	\$ -
Percentage	0.0%

Source: CIBC

Chart 2

Comparative Combined Federal and Provincial Tax Rates

	Personal Top Marginal Rates	Small Business Rates
Theoretical	43.50%	20.00%
BC	43.70%	13.50%
AB	39.00%	14.00%
SK	44.00%	15.50%
MB	46.40%	11.92%
ON	46.41%	16.00%
QC	48.22%	19.00%
NB	43.30%	16.00%
NS	50.00%	16.00%
PEI	47.37%	12.28%
NF	43.40%	16.00%

Source: CIBC

The result of this imperfect integration is that, in every province other than 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% in PEI to a high of 3.6% in Nova Scotia.

Chart 3

Tax Rate Advantage of Paying Dividends over Salaries—All Provinces

Province	Tax Rate Savings
BC	1.0%
AB	1.2%
SK	2.5%
MB	0.8%
ON	3.1%
QC	-0.2%
NB	1.4%
NS	3.6%
PEI	0.3%
NF	1.1%

Source: CIBC

The Tax Deferral Advantage

But the tax rate advantage is only half the story if you do not need the cash personally. For example, where you have other sources of cash to fund your personal living expenses, it may not be necessary to extract any funds from the corporation at all. In this case, a generous, potentially long-term tax deferral can be achieved by simply 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.

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 and the rate of return earned on the funds (see under "Role of Asset Allocation" below).

Chart 4

Tax Deferral Opportunity of Funds Left in the Corporation—All Provinces

Province	Tax Deferral
BC	30.2%
AB	25.0%
SK	28.5%
MB	34.5%
ON	30.4%
QC	29.2%
NB	27.3%
NS	34.0%
PEI	35.1%
NF	27.4%

Source: CIBC

As outlined in Chart 4, this tax deferral ranges from a low of 25% in Alberta to a high of over 35% in PEI.

Payroll Taxes on Salaries

The other downside of 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 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 the employee must contribute 4.95% 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 of \$4,326 contribution to fund the pension.

While paying enough salary to maximize CPP entitlements is often touted as one of the benefits of salary over

dividends (which are not considered pensionable earnings for purposes earning CPP entitlements), it's questionable 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.¹

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

For ownership of 40% 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 salary instead of dividends, which are not subject to EI premiums.

Other Payroll Taxes

Some provinces levy an additional payroll tax which can increase the cost of salary remuneration. For example, in Ontario, corporations that pay total remuneration to all employees exceeding the \$400,000 exemption must pay 1.95% Ontario Employer Health Tax ("EHT"), an additional burden associated with salary that is not payable on dividend remuneration.

Rethinking Conventional Wisdom

In summary, small business owners may actually be better off if they paid themselves enough dividends each year to fund current consumption and retained 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 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 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 also taxed in the year received. Only 50% of capital gains are taxed and only when they are realized. The after-tax corporate investment income (including the 50% 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% 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 but rather are taxed at much higher corporate 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.

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

When one compares 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 primarily because income tax is not paid immediately on investment returns leaving more capital to be reinvested. However, it is important to remember that the traditional advantages associated with earning capital gains (taxable at 50%) or Canadian portfolio dividends (eligible for the dividend tax credit) are completely lost when this type of investment income is earned inside an RRSP while these tax advantages are preserved when earned inside a corporation.

¹ For example, ignoring inflation of both CPP contributions, the retirement pension and ignoring any real growth in wages, imagine investing \$4,326 for 40 years to collect a \$11,210 CPP pension from age 65 to say age 82. The implicit real rate of return in this admittedly unrealistic example is a mere 0.49%. This also ignores the tax deductibility of the CPP to the business and the tax credit to the employee, which mitigates the cost of both the employer's and employee's contributions. Informal discussions with several actuaries more realistically estimated internal rate of return for present CPP contributors to be around 3%.

A Detailed Example

Assumptions

It is our position that business owners would end up with more money after-tax by funding their personal living requirements with dividends and leaving the excess cash in the company as opposed to paying the salary required to maximize the RRSP contribution. To test this hypothesis, we built a model to compare the net after-tax cash amounts to a business owner under two hypothetical scenarios over a 20 year period:

- A. *Pay salary to maximize RRSP contribution:* A business owner receives enough salary to maximize his RRSP contribution in the following year and lives off his remaining after-tax salary (his "after-tax spend amount").
- B. *Retain surplus funds in corporation:* Instead of making an RRSP contribution, surplus funds are invested within the company. The corporation pays the business owner sufficient dividends to have the same after-tax spend amount each year as under Scenario A.

In both scenarios, the funds are invested in the same portfolio of investments (see below for portfolio assumptions) for a period of 20 years.

In Scenario A, the RRSP would be fully liquidated at the end of 2030 and would be taxed at top marginal personal rates. In scenario B, the corporation pays tax annually on its active business income at the small business rate each year for 20 years (from 2010 to 2029). Investment income is taxed each year at the higher corporate rate while capital gains are deferred. In addition, the investments are allowed to grow for an additional year before liquidating. At the end of 2030, the business owner would liquidate all of his investments inside the corporation and extract all of the after-tax corporate funds through a combination of a tax free capital dividend and a non-eligible dividend and pay the appropriate personal tax.

In addition, the following assumptions were made:

1. The business owner makes the maximum RRSP contribution each year out of his salary and lives off his after-tax salary/bonus.
2. There are three possible investment portfolios:

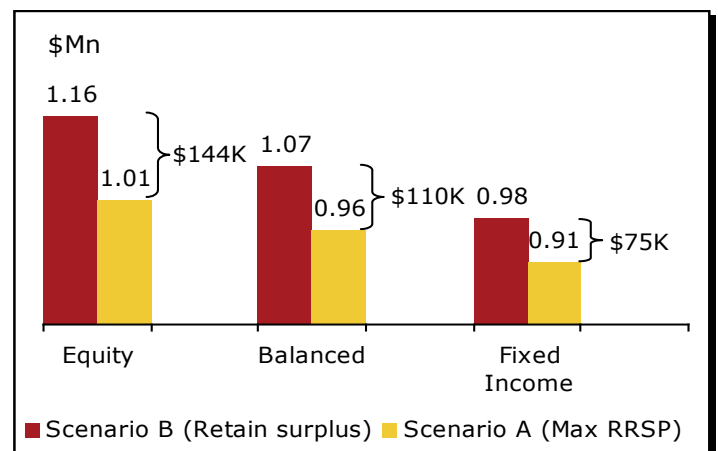
- a. Equity portfolio - 100% of funds invested in equities, generating deferred capital gains.
 - b. Balanced portfolio - 50% of funds are invested in equities, generating deferred capital gains and the remaining 50% in fixed income instruments.
 - c. Fixed income portfolio - 100% of funds are invested fixed income instruments.
3. The pre-tax rate of return on the equity and fixed income investments are both 5%.
 4. Ontario tax rates are used for both the corporation and the individual.
 5. Payroll taxes (CPP, EI, Ontario EHT) are ignored.
 6. For purposes of the calculations, no amounts were indexed to inflation (i.e. no growth in business income, RRSP dollar limits, tax credits or after-tax spend amount) and the tax rates were assumed to remain constant until 2030.

Results for active business income of \$150,000, spend amount of \$72,000

At pre-salary corporate income of \$150,000, with an assumed after-tax spending amount required of about \$72,000, our model showed that Scenario B (invest surplus funds in the corporation) outperformed Scenario A (maximize RRSP) strategy in all three investment portfolios. That is, under each investment portfolio, after

Chart 5

Net After-Tax Cash Available to Ontario Business Owner (at business income of \$150K)



Source: CIBC

20 years, the business owner would have more after-tax cash available if he received dividends and left surplus funds inside the corporation instead of paying enough salary to maximize an RRSP contribution.

There are 3 reasons for this result:

- 1) There is simply less tax paid by having the income taxed in the corporation and flowing it to the shareholder as a dividend. This is the tax rate advantage described above.
- 2) There is more money to invest in the corporation when personal tax is not paid immediately on cash not needed currently by the owner. This is the tax deferral advantage described above.
- 3) As discussed above, the preferred tax treatment afforded to capital gains and Canadian portfolio dividends is not available when the investments are in an RRSP.

As Chart 5 shows, Scenario B truly outperformed in the Equity portfolio as the capital gains were taxed only upon realization when the investments were liquidated, thereby maximizing the benefit of tax deferral at the corporate and personal levels.

Role of Asset Allocation

Capital Gains and Interest Income

Since capital gains are only taxed upon realization while interest income is fully taxable annually, even with the same rate of return assumption of 5% for both equities and fixed income, the total after-tax savings amounts for the Equity or Balanced portfolios under either Scenario A or B results in higher values than the Fixed income portfolios.

In other words, corporately-held portfolios with a higher allocation of equities that generate deferred capital gains are expected to perform better than portfolios more heavily weighted with fixed income investments that generate interest income that is taxed annually.

This also explains why the differential between Scenario A and B is greatest with an Equity portfolio (\$143,558) and least with the Fixed income portfolio (\$75,133) since the fixed income is already sheltered within an RRSP (Scenario A) but taxed annually if earned inside the corporation (Scenario B).

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 since investments that would have been exposed to tax, and 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, other factors for consideration include eligibility for the lifetime capital gains exemption, creditor protection issues, and income splitting opportunities.

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" (interpreted to mean 90% 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 must have owned the shares for at least two years prior to their disposition and during that entire two year period, more than 50% of the corporation's assets must 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 of them 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 prepaying 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 Registered Retirement Income Funds (RRIFs) are protected from creditors upon bankruptcy, other than contributions made within the final 12 months prior to bankruptcy. Investments inside a corporation do not enjoy the benefit of creditor protection and as a result, should generally not be held in an operating company but rather in a holding company or sister company, as contemplated in a purification strategy discussed above.

Income Splitting

One of the benefits of contributing to an RRSP is the ability, in the withdrawal phase, to ultimately split pension income

with a spouse or partner. Pension income doesn't include RRSP withdrawals but does include RRIF withdrawals, once the annuitant is 65 years of age or older.

On the other hand, if funds are left in the company instead of contributed to an RRSP, additional opportunities for income splitting through the payment of dividends are available to the owner if shares are issued to a spouse and children (over age 18). Dividends paid on shares held by a spouse or adult child may be taxed at a lower rate than the owner and thus income splitting can be accomplished in this manner.

Tax & Estate Planning

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