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TAX MATTERS

How small-business owners can save for retirement

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When it comes to being an entrepreneur, folks have tried just about everything. If you're old enough, you'll remember Gary Dahl, the man who invented the Pet Rock – and made millions selling these things. In fact, you can still buy Pet Rocks today. And then there's the entrepreneur who invented glow-in-the-dark toilet paper. Supposedly, based on the reviews, it feels like tree bark – but could be ideal for the person who has everything (as an aside: I did try ordering some on Amazon, but they were out of stock).

While there are perks to being a small-business owner, there are challenges, too. Not the least of which is navigating our tax system, which became significantly more complicated in 2017 with the introduction of new rules that, among other things, penalize business owners for using their corporations to accumulate savings for retirement. Today, I want to revisit those rules and provide some ideas that could help business owners set aside money for the future.

THE RULES

The small-business deduction (SBD) is a special deduction available to Canadian-controlled private corporations (CCPCs) that can reduce the overall tax rate paid by smaller companies on the first $500,000 of active business income. This lower tax rate is considered an important incentive to help business owners in their plight to start and expand small businesses – the backbone of the Canadian economy.

But rules were introduced in 2017 – called the passive investment income rules – that limit your access to the SBD for tax years that begin after 2018. How so? The rules say any CCPC that earns more than $50,000 of investment income in the previous year will generally face a reduction in the amount of income eligible for the reduced small business rate.

Specifically, the $500,000 small-business limit is reduced by $5 for every $1 of investment income (called adjusted aggregate investment income, or AAII) above the $50,000 threshold. This means the $500,000 limit is eliminated when AAII reaches $150,000 in the previous tax year. The extra tax paid by your corporation can be as high as $60,000 to $100,000 each year, depending on your province, with an average higher tax bill of $82,000 across the country when the small-business limit is fully clawed back. And by the way, the investment income earned is aggregated for all associated corporations when figuring out whether you've reached the $50,000 limit for AAII.

So, the problem is many small-business owners who rely on their businesses to earn profits that they can save for the future (that is, their corporations become something of a pension fund for the future), face reduced levels of saving inside their companies.

THE IDEAS

There are a few ideas that can help you keep access to the full SBD and thereby make saving for the future easier. The key is to reduce the amount of AAII earned annually in your company.

1. Control asset allocation. By adjusting your asset allocation inside your corporation that holds the passive investments, you can potentially reduce the amount of AAII being reported each year. It could make sense, for example, to change your portfolio so more of your equities are held in your corporation. Any capital gains realized inside the corporation are, at least today, just 50 per cent taxable. Further, you can defer the tax and avoid reporting taxable income on unrealized capital gains by continuing to hold those investments for the long term. The fixed income portion of your portfolio may be best held outside your corporation, perhaps in your registered retirement savings plan or tax-free savings account, where the highly taxed interest income won't give rise to more taxes.

2. Invest in life insurance. I'm talking here about a permanent life insurance policy that allows you to accumulate cash value, or investments, inside the policy. Any income earned inside the policy avoids annual income tax and is not included in AAII. Further, the proceeds of the policy will pay out tax-free upon death of the insured and will also bump up the capital dividend account of the corporation. This means your heirs will be able to withdraw funds from the corporation on a tax-free basis later by paying tax-free capital dividends out of the company.

3. Consider an individual pension plan. An IPP is basically a registered pension plan set up for one individual (typically the business owner) and perhaps family members as well. The corporation can deduct contributions to an IPP, and the investments will now be held inside the IPP where annual income avoids tax and side-steps the definition of AAII. In addition, many business owners can set aside more in an IPP than they could in an RRSP. This can make sense for businesses that are consistently profitable.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached at tim@ourfamilyoffice.ca