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TAX MATTERS

Business owners need to weigh RRSPs and their corporations as retirement options

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I'm a business owner, and I think my kids also have the entrepreneurial bug. But I'm careful to make sure they understand that while business ownership comes with a lot of benefits, it also presents some specific challenges when saving for retirement. Let me explain.

The options

If you operate your business through a corporation, as most do, you have some tax benefits available. Most notably, you'll pay less tax on the first $500,000 of active business income you earn in your corporation than you would if you earned the income personally.

This means that you can be left with more money, after taxes, to invest for retirement if you earn your income through a corporation. Take Wendy as an example. She lives in Ontario and earns $200,000 in business income. In her corporation, she'll pay tax of just 12.2 per cent, or $24,400, and will be left with $175,600 to invest after taxes. If she earns it personally, she'll pay taxes of $67,008, and will be left with $132,992 to invest. So, there's a sizable tax deferral available when the income is earned through the corporation.

Now, when Wendy eventually distributes the corporate funds to herself – generally as a taxable dividend – perhaps for retirement, she'll pay tax personally. So, the deferral of tax will end. It's also true that Wendy may not have the full $175,600 available to invest in her corporation since, presumably, she's going to need some money to live on during her working years. She could pay herself salary for this and defer tax on the balance that she leaves in the company.

As a business owner you might conclude that, after taking money from your corporation to live on, you should keep the balance in the company to invest for retirement given the tax deferral available. But hold on. There's another option here. What if you were to pay additional salary to yourself to contribute to your RRSP? The RRSP also provides a tax deferral since you won't face tax on the amount contributed thanks to the RRSP deduction. You'll defer tax until you make RRSP withdrawals later in retirement.

The math

Suppose that Wendy pays herself salary of $200,000 (all the income of the corporation), contributes $30,780 of this to her RRSP (the maximum RRSP contribution room for 2023), pays taxes of $52,146, and spends the rest, or $117,074, on costs of living.

If we compare this with a situation where she pays herself enough salary to provide for costs of living (this would mean a salary of $169,220, leaving $117,074 after taxes), it will leave $27,025 in the corporation after corporate taxes to invest in the company.

So, basically, she'll be able to invest more in her RRSP in this situation than she'll be able to keep invested in her corporation if she pays herself additional salary (which is deductible to the company) to make the RRSP contribution. The reason is that her corporation must pay tax of $3,755 on its income.

As for cash in her pocket in retirement, we do have to factor in taxes owed by the corporation over the years if she chooses to invest in her company, taxes owing when paying dividends to herself from her corporation in retirement, and taxes owing on RRSP withdrawals. The bottom line? She'll generally have more in her hands, after taxes, in retirement when paying additional salary to herself each year to maximize her RRSP contributions.

The tips

As a business owner, consider these tips:

- You'll almost always be best off if you pay yourself enough salary to cover your costs of living, then additional salary or a bonus to contribute as much as possible to your RRSP.
- It generally does not make sense to pay yourself salary strictly to create the maximum RRSP contribution room possible (salary of $175,333 will provide the maximum RRSP room of $31,560 for 2024) if you don't otherwise need the salary to meet your costs of living. You'd be left investing any excess (amounts you don't need to live on) outside your RRSP, which is taxable annually and is not as good as leaving the funds in your corporation to invest.
- There are many other considerations when deciding to pay yourself salary, dividends or keeping funds invested in your corporation. Speak to a tax pro about it.

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