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.[1] 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,[2] 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 In that report, however, it was assumed that personal funds, once withdrawn from the corporation, would be invested in a non-registered account, leaving investment income exposed to taxes.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 This report will show that, instead of leaving funds in your corporation for investment, using funds withdrawn from your corporation to maximize your TFSA may be a smart choice.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.[3] As a result, to make a TFSA contribution using income from your company, 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 to your TFSA. The answer is affected by corporate and personal tax rates, which vary by province or territory, and whether business income is eligible for the small business deduction (SBD Income)[4] or is General Income that is not eligible for the small business deduction.[5]

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[1] Throughout this article, it is assumed that the TFSA contribution rules are followed and there are no over-contributions.

[2] The report "Bye Bye Bonus" is available online at cibc.com/ca/pdf/jg-dividends-bonus-en.pdf.

[3] Throughout this report, it is assumed that you are the shareholder and that you pay personal tax at the highest combined federal and provincial or territorial marginal tax rate.

[4] The small business deduction is available to Canadian controlled private corporations (CCPCs) that earn active business income up to the annual small business limit, which in 2021 is $500,000 federally and in all provinces and territories other than in Saskatchewan, where it is $600,000.

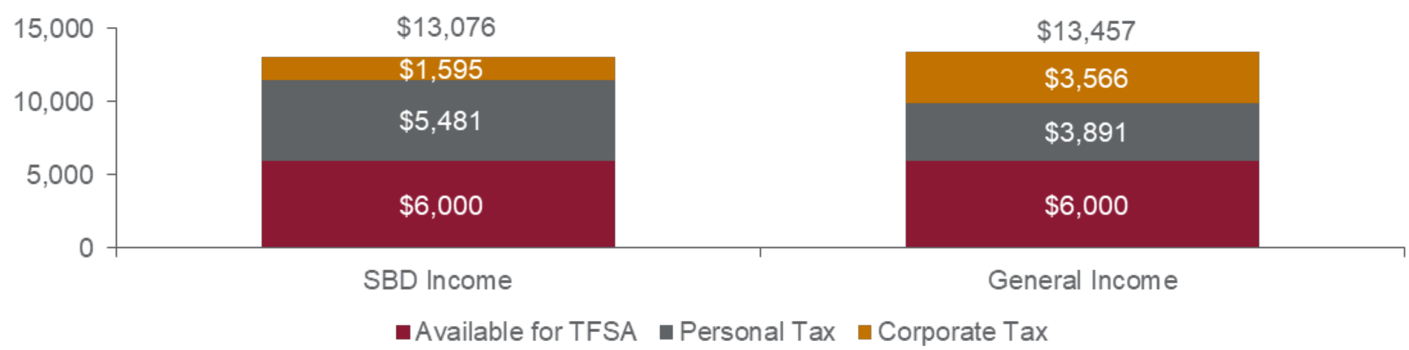
[5] The amount of business income that is required would also differ if corporate funds were distributed as salary / bonus, rather than dividends. In fact, it may be slightly advantageous to distribute corporate funds as salary / bonus rather than dividends in 2021 due to a small tax cost that exists in many provinces and territories. 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.

The amount you can contribute to a TFSA is based on your "TFSA contribution room." You automatically accumulate TFSA contribution room for each year after 2008 in which you are at least 18 years old and resident in Canada. Your TFSA contribution room is cumulative and unused room is carried forward indefinitely to future years. If you have been resident in Canada and at least 18 years old since 2009 and, as of 2021, have not yet opened up a TFSA, you can immediately contribute $75,500 to a TFSA.[6]

Suppose you wanted to contribute $6,000 to your TFSA in 2021. Figure 1 shows that your corporation would need to earn $13,076 of SBD Income in Ontario in 2021. After paying corporate tax of $1,595 there would be $11,481 left to be paid to you as a non-eligible dividend.[7] Personal tax of $5,481 would be payable on the dividend leaving $6,000 in your hands for you to make the TFSA contribution.

Alternatively, if your corporation earned $13,457 of General Income in Ontario in 2021, Figure 1 shows that corporate tax would amount to $3,566 (which is higher than for SBD Income) leaving $9,891 to be paid as an eligible dividend. After paying personal tax of $3,891 (which is lower than for a non-eligible dividend), you would net $6,000 for your TFSA contribution.

Figure 1: Corporate income required to yield $6,000 for TFSA contribution in Ontario in 2021



Source: Calculated by CIBC from information provided by *Tax Templates Inc.*, as of March 2021

Since provincial and territorial tax rates vary, Figure 2 shows how much business income (either SBD Income or General Income) 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 $6,000 to your TFSA after corporate and personal taxes in each province and territory in 2021.

Figure 2: Business income & dividends needed to make a $6,000 TFSA contribution in 2021

Province or territory	SBD Income	Non-eligible dividend	General Income	Eligible dividend
AB	$11,685	$10,400	$11,862	$9,134
BC	$13,190	$11,739	$12,952	$9,455
MB	$12,364	$11,251	$13,210	$9,643
NB	$12,975	$11,483	$12,710	$9,024
NL	$12,305	$10,828	$14,936	$10,455
NS	$13,108	$11,601	$14,465	$10,270
NT	$10,671	$9,497	$11,390	$8,372

6 Consisting of $5,000 of accumulated room for each of 2009 through 2012, $5,500 for 2013 and 2014, $10,000 for 2015, and $5,500 for 2016, 2017 and 2018 and $6,000 for 2019, 2020 and 2021.

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

Province or territory	SBD Income	Non-eligible dividend	General Income	Eligible dividend
NU	$10,960	$9,645	$12,282	$8,966
ON	$13,076	$11,481	$13,457	$9,891
PE	$12,533	$11,154	$13,219	$9,121
QC	$13,174	$11,543	$13,630	$10,018
SK	$11,425	$10,397	$11,682	$8,528
YT	$11,782	$10,722	$11,564	$8,442

Source: Calculated by CIBC from information provided by *Tax Templates Inc.*, as of March 2021

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 2021 to invest either within a corporation or via a TFSA.

Suppose your corporation earned $13,076 of SBD Income. In Figure 1, we saw that after paying corporate tax of $1,595 there would be $11,481 remaining in the corporation. Your choices for this after-tax SBD Income include:

1. **Investing in a TFSA**: You may withdraw $11,481 from your corporation in 2021 as a non-eligible dividend, pay personal tax of $5,481 and have $6,000 in your hands, which could be invested in a TFSA.
2. **Investing in your corporation**: You may leave the $11,481 in your corporation in 2021, which could be used by the corporation to invest. When the $11,481 is ultimately distributed to you as a non-eligible dividend in some future year, you would still ultimately pay personal tax of $5,481 (assuming tax rates do not change) and have $6,000 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 $13,076 of SBD Income that ultimately reaches your hands, after corporate and personal taxes are paid. You would always receive $6,000(assuming tax rates do not change.)

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

The corporate tax deferral

The first difference is that with corporate investing, there is tax deferral of $5,481, since 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 ($11,481) than your TFSA ($6,000).

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.

Taxes on investment income

The second difference is that 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.

The question is, would you be better off with:

3. **Corporate investments, which have an initial higher amount for investment but produce taxable income, or**
4. **Personal investments, which have a lower initial amount for investment but produce non-taxable income?**

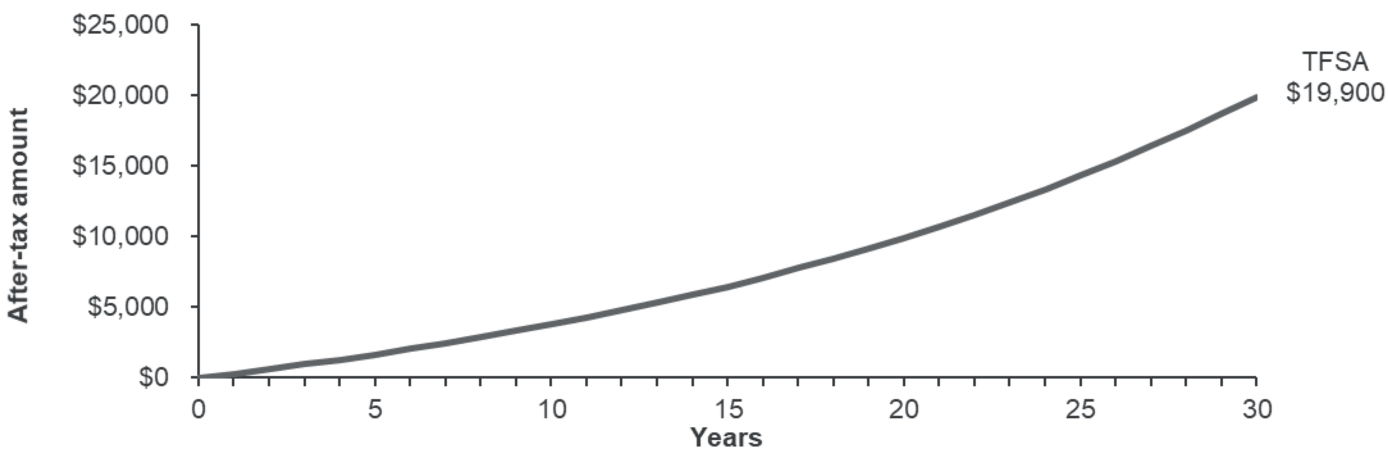
Let's continue with our Ontario example, assuming a 5% rate of return on investments[8] and 2021 tax rates,to illustrate how the tax deferral and taxes would affect the amount available with corporate investments in the short and long term, compared to a TFSA.

Investing in a TFSA: All types of income

If you invested a one-time $6,000 contribution in a TFSA at a 5% rate of return, after one year, you would have $300 ($6,000 x 5%) of investment income. For all types of income, a TFSA is completely tax-free, so the full $300 would be available to you.

Figure 3 shows that if you were to reinvest income within a TFSA, after 30 years you would have accumulated total income of $19,900 (in addition to the original capital of $6,000). With no taxes, the total investment income in a TFSA will always be $19,900 after 30 years for each type of income and in every province and territory. You might say that TFSAs are truly an "equal-opportunity" investment.

Figure 3: Tax-free investment income if $6,000 is invested (once) in a TFSA, 5% rate of return



Investing in your corporation

By leaving after-tax SBD Income in the corporation, you would have $11,481 of capital to invest. At a 5% rate of return, the corporate investments would yield $574 of income in the first year, regardless of the type of income. This is 91% more than the $300 of TFSA investment income because 91% more of initial capital is available with a corporation ($11,481) than with a TFSA ($6,000).

The downside 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 in the corporation 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 "after-tax investment income" from the corporate investments.[9]

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8 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 in today's historic low interest rate environment, 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 of return on investment.

9 In this report, the "after-tax investment income" excludes the after-tax SBD Income, which provided $11,481 of capital for corporate investments and yields $6,000 once it is withdrawn from the corporation and personal taxes are paid.

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.[10] Consequently, the net investment income ultimately available through corporate investing varies with the type and taxation of investment income that is earned.

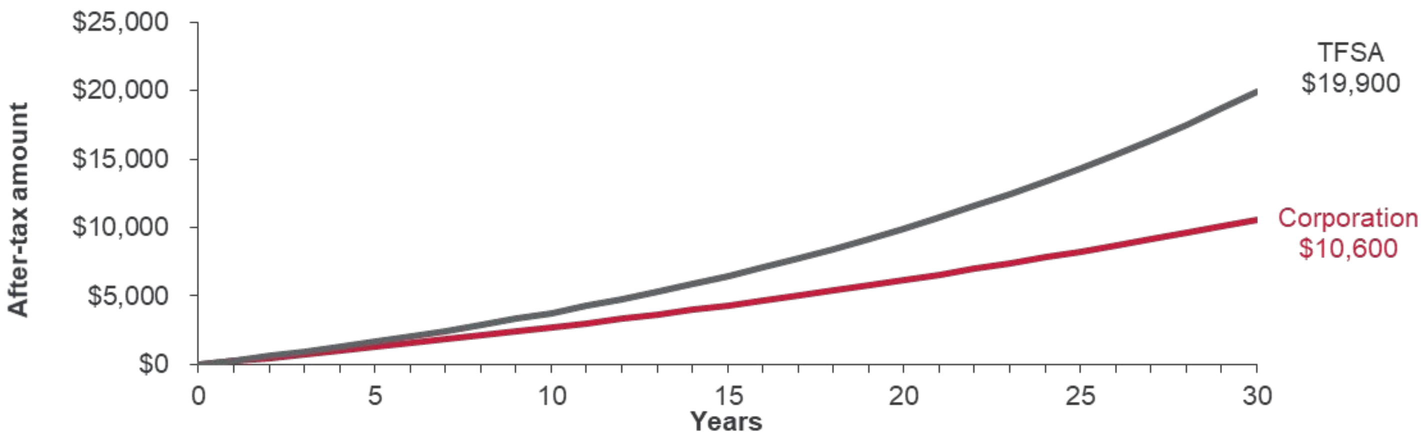
Interest

If your corporation earned $574 ($11,481 times 5%) of interest income, after paying corporate tax on the income and personal tax on the non-eligible dividend, you would be left with $241 of after-tax investment income.[11] This is less than the $300 available with a TFSA, as determined above.

Over 30 years, corporate taxes would erode the amount that may be reinvested, impacting total investment income. Figure 4 shows that after 30 years, the after-tax investment income you'd receive would amount to just $10,600 (about 47% less than the $19,900 in a TFSA).

In summary, if 5% interest income is earned and 2021 tax rates for Ontario apply, investing in a TFSA is always a better option than corporate investing over a 30 year time period.

Figure 4: After-tax investment income if $11,481 is initially invested in a corporation vs. $6,000 in a TFSA, earning 5% interest income and using 2021 tax rates for Ontario



Canadian eligible dividends

Let's say your corporation invests in Canadian stocks that earn $574 ($11,481 times 5%) of eligible dividends. After corporate and personal taxes are paid, the net investment income would total $348,[12] which is more than the $300 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.[13] After 30 years, the after-tax investment income would amount to $16,800 (about 16% less than the $19,900 in a TFSA).

As we can see, if 5% eligible dividend income is earned and 2021 tax rates for Ontario apply, after-tax investment income would initially be slightly higher with corporate investments than with a TFSA. In the long run, however, starting after about 16 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.

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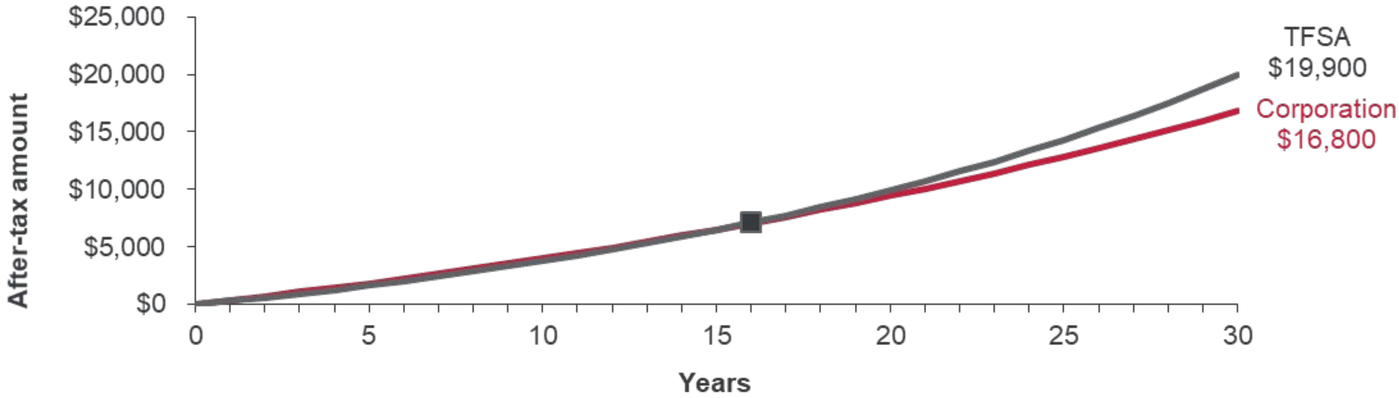
[10] The report "In Good Company" is available online at cibc.com/ca/pdf/small-business/in-good-company-en.pdf.

[11] Using Ontario 2021 tax rates, $574 of corporately-earned interest income is taxed at 50.17%, of which 30.67% is refundable. This leaves $462 {$574 times [1 minus (0.5017 minus 0.3067)]} that can be paid out as a non-eligible dividend. After personal tax at 47.74%, the after-tax cash available is $241 [$462 times (1 minus 0.4774)].

[12] In Ontario in 2021, if a corporation earns $574 of eligible dividends, corporate Part IV tax is $220 ($574 x 38.33%). 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, $574 may be distributed as eligible dividends. Personal tax on the dividends would amount to $226 ($574 x 39.34%) leaving net investment income of $348 ($574 - $226).

[13] Corporate Part IV tax of 38.3% on eligible dividends is less than corporate tax of 50.17% on interest.

Figure 5: After-tax investment income if $11,481 is initially invested in a corporation vs. $6,000 in a TFSA, earning 5% eligible dividends and using 2021 tax rates for Ontario



Capital gains realized annually

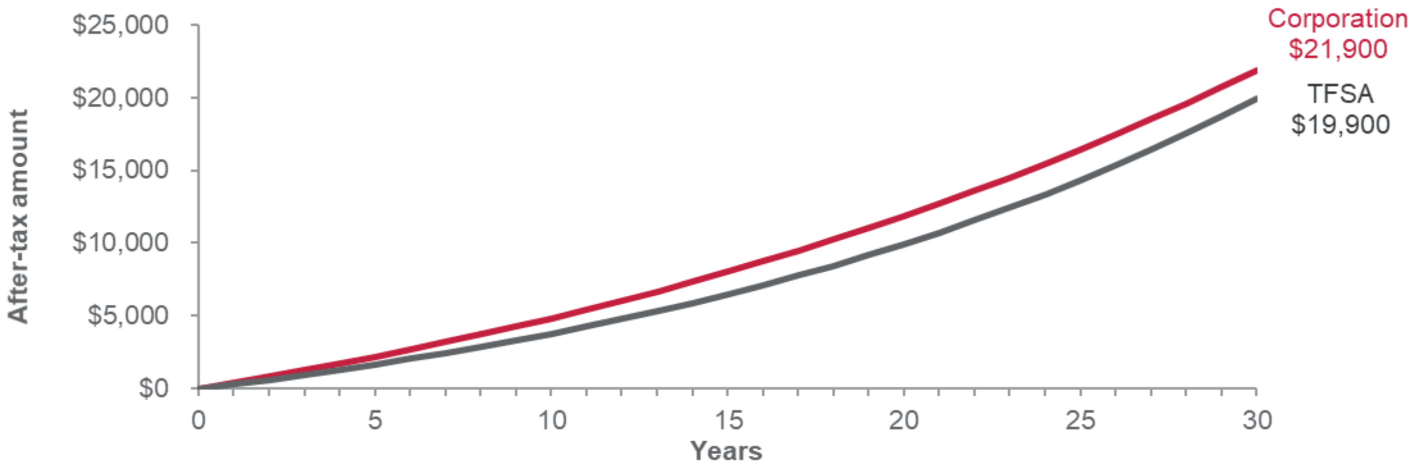
If your corporation realized $574 ($11,481 times 5%) of capital gains in the first year, corporate and personal taxes would total $166.[14] The after-tax investment income of $408 that you'd receive with corporate investing is more than the $300 with a TFSA after one year.

Figure 6 shows that after 30 years, after-tax investment income with a corporation would be $21,900, which is only slightly more than the $19,900 that would be available from a TFSA.

If 5% capital gains are realized annually and 2021 tax rates for Ontario apply, we can see that over 30 years corporate investing yields about the same amount of after-tax investment income as a TFSA. (Over a longer term, the TFSA would outperform corporate investments. Again, the crossover point is dependent on the rate of return achieved on the underlying investment.)

[14] Using Ontario 2021 tax rates, 50% of the $574 capital gain in the corporation can be distributed as a $287 capital dividend, which is generally tax-free. The other 50% is taxed at 50.17%, of which 30.67% is refundable, thus netting $231 {$574 times 50% [1 minus (0.5017 minus 0.3067)]} that can be paid out as a non-eligible dividend. After personal tax at 47.74%, the after-tax cash available is $121 [$231 times (1 minus 0.4774)] + $287 of capital dividend, for a total after-tax cash of $408.

Figure 6: After-tax investment income if $11,481 is initially invested in a corporation vs. $6,000 in a TFSA, earning 5% annual capital gains and using 2021 tax rates for Ontario



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 $574 ($11,481 times 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 $166, netting $408 with corporate investing.

If the capital gain was not realized annually , 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, net investment income to the shareholder (after all personal and corporate taxes are paid) would be $27,100 (36% higher than the $19,900[15] a TFSA).

As we can see, if 5% of deferred capital gains are earned and 2021 tax rates for Ontario apply, corporate investing always outperforms a TFSA.

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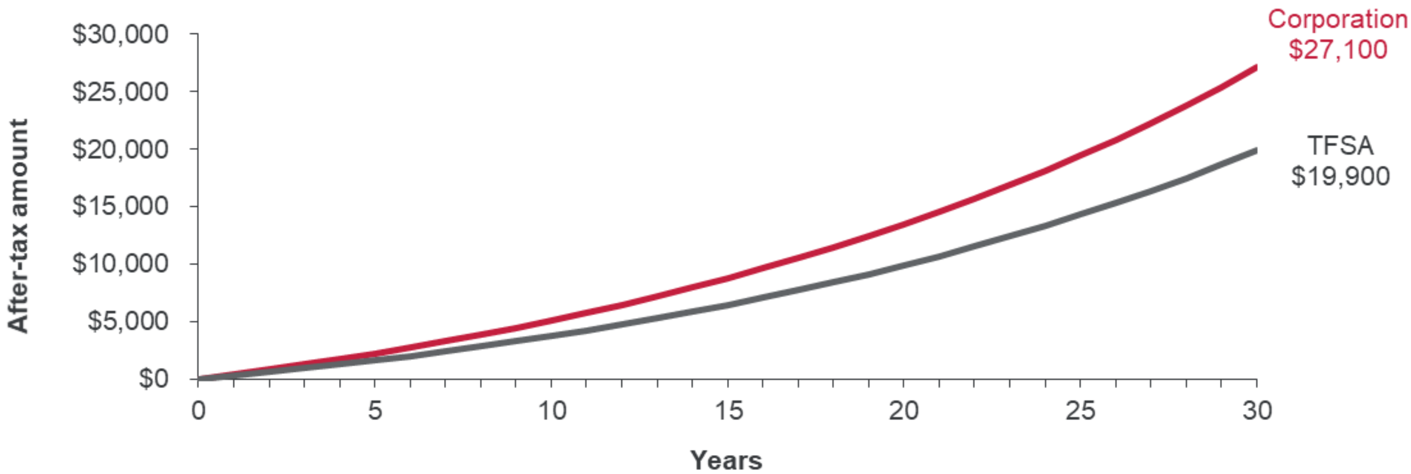
15 Deferred capital gains are not taxed annually in a TFSA or in a corporation (corporate tax only applies in the year that any after-tax investment income is distributed as a dividend).

Figure 7: After-tax investment income if $11,481 is initially invested in a corporation vs. $6,000 in a TFSA, earning 5% deferred capital gains and using 2021 tax rates for Ontario



More about the key differences between corporate investments and a TFSA

Tax deferral

We saw in the examples above that the high tax deferral on SBD Income makes it possible to invest significantly more capital in a corporation than in a TFSA. In 2021, the tax deferral on SBD Income in the provinces and territories ranges from 32.5% (in Nunavut) to 42.5% (in B.C. and Nova Scotia).

The tax deferral for General Income, on the other hand, is significantly lower in 2021, ranging among the provinces and territories from 17.5% (in Nunavut) to 27.0% (in Ontario). Due to the lower tax deferral with General Income compared to SBD Income, it is less likely corporate investments will outperform a TFSA when the corporation initially earns General Income 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. If we were to extend the example beyond 30 years, corporate investing would never outperform 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. If we were to extend the example beyond 30 years, corporate investing would always outperform 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. If we were to extend the example beyond 30 years, despite the preferable rates, annual taxes would still erode the benefit from tax deferral 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 and territorial tax rates on investment income also vary. When tax rates are high, corporate investments are less likely to outperform a TFSA than when taxes are lower.

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 would 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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