Tax + Estate Business Owners Kit

Part 3 Pre-retirement planning

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Retirement planning is important for everyone, but it is especially important for incorporated business owners.

That's because business owners often invest significant time and money in their business with the hope that the value of the business will eventually form a significant component of their retirement plan.

As a result, it is critically important to plan ahead to identify opportunities for growth, capital preservation and tax minimization.

Part 3 of the Tax and Estate Planning for Incorporated Business Owners kit discusses important considerations in maximizing retirement savings, utilizing the Lifetime Capital Gains Exemption (LCGE), tax strategies and other important considerations in retirement planning.

This is Part 3 of the Tax and estate planning for incorporated business owners series

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RRSP contribution room is calculated as 18% of the previous years earned income.

Should I save for retirement in my RRSP, TFSA or through my active business corporation?

As an owner of an incorporated business, you may decide to use some of the business profits to save for retirement. This can be achieved by withdrawing profits from the business as salary or bonus and making contributions to RRSPs, TFSAs, or investing through your corporation by retaining business profits, or a combination of all three.

To make an RRSP contribution, you must have sufficient RRSP contribution room. RRSP contribution room is calculated as 18% of the previous years earned income, which generally includes salaries and bonuses, but not dividends. For 2021, RRSP contribution room is limited to a maximum of $27,830, which would require earned income in 2020 of $154,611. The payment of a salary/bonus also reduces the taxable income of a corporation, which reduces exposure to general corporate tax rates that apply once business income exceeds $500,000 federally and, in most provinces/territories. Therefore, under this option, the salary or bonus you receive from your corporation is reported on your personal tax return, with a deduction available with respect to the RRSP contribution.

Instead of making an RRSP contribution, another option is to make a contribution to your Tax Free Savings Account (TFSA). A TFSA allows you to contribute up to $6,000 per year (or up to $75,500 lifetime limit) and earn income within the TFSA on a tax free basis. Unlike an RRSP, contributions to your TFSA are not tax deductible. In addition, all withdrawals from the TFSA are not taxable. Therefore, under this option, the salary or bonus you receive from your corporation is taxable to you personally, and the remaining after-tax funds could be contributed to a TFSA.

Instead of paying yourself a salary to make an RRSP or TFSA contribution, you may choose to leave the profits in your corporation to be invested. In this scenario, the after-tax business profits can be invested in the corporation, with the proceeds set aside for retirement. You will not face any personal taxation until the corporation distributes the after-tax retained earnings to you in the future, by way of a taxable dividend.

Each strategy has its benefits and drawbacks outlined in Table 1 on the next page:

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Table 1

	Benefits	Drawbacks
RRSP	• Salary/bonus deductible in the corporation-reducing taxes payable • Tax deferral on investment income earned in plan • Reduce passive assets in the corporation – access to the Lifetime Capital Gains Exemption (LCGE) and Small Business Limit (SBL)	• Salary (less RRSP contribution) fully taxable • Future RRSP (RRIF) income fully taxable
TFSA	• Salary/bonus deductible in the corporation • Investment income earned is tax exempt • Withdrawals are tax exempt • Withdrawals re-establish contribution room in the year following withdrawal • Provides a tax efficient source of income in retirement	• Salary paid is fully taxable personally • Contributions are not tax deductible • Lower contribution limits relative to RRSP & corporate investing
Corporation	• Tax deferral on business profits retained in the company (see Income in a Corporation tax card for active business income) • Investment income retains its character	• Annual taxation on investment income • Higher corporate tax rate applies to investment income and no deferral opportunity (see Income in a Corporation tax card for investment income) • Excessive passive income may jeopardize access to the small business limit • Excessive passive assets may jeopardize an individual's ability to utilize the LCGE • CPP benefits may be lower in retirement

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The important question many incorporated business owners have is, which option produces a better result? That is, can you accumulate more wealth by paying enough salary to make RRSP contributions, TFSA contributions, or should you save for retirement by retaining the after-tax profits from the business and investing in the corporation?

The answer is, like many things in tax, it depends. There are a variety of factors that will determine which option is the best for your retirement plan.

Two factors in this decision are the following;

1 Your effective personal tax rate

Both at the time the investment is made as well as in the future upon withdrawal from either option.

2 Your investment strategy

The types of investment returns that are earned within your corporate investment portfolio

Consider Michelle, who lives in Ontario and operates a home renovation business through a corporation. The corporation has pre-tax active business income of $154,611. Investments earn a 6% rate of return.

Michelle is currently taxed at the top marginal rate, meaning all amounts withdrawn from her corporation are taxed at 53.53% for income, and 47.74% for non-eligible dividends. She also plans to retire in 15 years, where she expects to remain in the same, higher tax bracket. Michelle wants to know which option is best, RRSP or corporate investing.

Option 1 – RRSP

Under this option, Michelle pays a salary enough ($154,611) to make the maximum RRSP contribution for 2021 of $27,830. The RRSP contribution is invested over a 15-year period. At the end of 15 years, the funds are withdrawn from the RRSP (or RRIF) for retirement at the top tax rate of 53.53%. This strategy provides Michelle with personal cash flow of $58,915 (after paying income taxes on the salary).

Option 2 – TFSA

Under this option Michelle pays a salary equal to $154,611 (same as RRSP option) which is taxable to her personally. Then, Michelle makes a TFSA contribution, ensuring she has the same level of after-tax cash flow as the RRSP and corporate investing options equal to $58,915. As a result, the TFSA contribution is $12,933 and is invested over 15 years. At the end of 15 years, the funds are withdrawn tax free from the TFSA.

Option 3 – Corporate Investing

Under this option, Michelle pays a dividend out of the after-tax corporate profits large enough to provide the same amount of after-tax personal cash as the RRSP and TFSA option ($58,915). The non-eligible dividend equates to $112,735 (assuming Michelle is taxed at the top tax bracket and only claims the basic personal amount and non-eligible dividend tax credit). The corporate profit (after the non-eligible dividend payment) of $23,014 is invested in the corporation for 15 years. At the end of 15 years, the funds are withdrawn from the corporation and taxed at a non-eligible dividend rate of 47.74%.

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Below provides a summary of both options available to Michelle.

Table 2

RRSP vs. TFSA vs. Corporate investing	Option 1 RRSP investing	Option 2 TFSA Investing	Option 3 Corporate investing
Corporation			
Active Business Income	154,611	154,611	154,611
Salary paid to business owner[1]	(154,611)	(154,611)	0
Taxable income	0	0	154,611
Corporate tax	0	0	(18,863)
Available to distribute to individual shareholder	0	0	135,748
Dividend paid to individual shareholder	0	0	112,735
Amount invested in corporation	0	0	23,014
Individual shareholder			
Salary/dividend received	154,611	154,611	112,735
RRSP contribution[2]	(27,830)		0
Taxable income	126,781	154,611	129,645[3]
Personal income tax	(67,866)	(82,763)	(53,820)
TFSA contribution[4]		12,933	
Net cash for day to day consumption	58,915	58,915	58,915
Summary			
Net cash for day to day consumption	58,915	58,915	58,915
RRSP/TFSA/Corporate investment	27,830	12,933	23,014

Assumptions
1. Amount required to maximize RRSP contributions
2. Assumes previous year's income is the same as current year
3. Non-eligible dividend subject to a 15% gross-up
4. TFSA contribution room is available

The results

Let's review Michelle's RRSP and TFSA portfolios versus the corporate investment strategy (on the basis of the assumptions set out below). The RRSP portfolio at the end of 15 years has a market value of $66,696. After paying income taxes upon the withdrawal (at top rates), Michelle is left with $30,994 after-tax to help fund her living expenses in retirement. This is the result regardless of the type of returns earned in the RRSP, since various forms of investment income do not receive preferential tax treatment and are fully taxable at the time of withdrawal.

On the other hand, the TFSA portfolio at the end of 15 years has a market value of $30,994. Since withdrawals from a TFSA are tax exempt, Michelle has the full $30,994 available to her in retirement to fund living expenses. Similar to the RRSP portfolio, the market value is the same regardless of the type of returns earned in the TFSA, since all investment income is tax-exempt.

For the corporate portfolio, the type of investment return earned does make a difference in the net proceeds available to Michelle on an after-tax basis. Therefore, the following is a comparison of the results for three corporate investment portfolios, where the assumed annual 6% return is derived as follows:

1 Interest & Foreign income

All returns are fully taxable each year

2 Balanced portfolio

50% returns are interest and/or foreign income, 25% are realized capital gains, and 25% deferred capital gains

3 Deferred capital gain

No annual taxation until end of year 15, where the corporate portfolio is sold and distributed to the individual shareholder.

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Table 3.A below summarizes the after-tax proceeds for each of the portfolios. As you can see, the best option is dependent upon the types of returns that are earned in the corporate portfolio. The RRSP and TFSA portfolios provide higher levels of after-tax proceeds compared to a corporate portfolio when the returns are comprised entirely of fully taxable income (i.e., interest & foreign income) as well as the balanced portfolio. The portfolio which derives its returns from 100% deferred capital gains provides a higher level of after-tax proceeds than the RRSP and TFSA. Therefore, Michelle's best alternative is dependent upon how tax efficient a corporations investment returns are. If more tax efficient, higher after-tax dollars can be saved through her corporation. If the investment returns are less tax efficient, the RRSP and TFSA provide higher savings in retirement. It is important to note that the RRSP and TFSA will provide the same level of after-tax income in retirement when current tax rates and future tax rates are constant.

Table 3.A

RRSP vs. TFSA vs. Corporate investing over 15 years

	RRSP All portfolios	TFSA All portfolios	Corporate investing: Interest & Foreign Inc.	Corporate investing: Balanced portfolio	Corporate investing: Deferred capital gains
Pre-tax market value of RRSP/TFSA/ Corporate investment	66,696	30,994	35,802	42,162	55,154
Non-eligible dividend paid (Corporate investment only)			43,673	46,829	35,950
Personal income taxes	(35,702)	0	(20,849)	(19,027)	(17,163)
Capital dividend account				6,974	16,070
After-tax proceeds to individual shareholder	30,994	30,994	22,823	27,802	34,858

Assumptions

2021 Ontario corporate & top personal tax rates assumed in analysis. Rate of return in all portfolios is 6% annually. Returns in the balanced porfolio include 3% interest & foreign income, 1.5% realized annual capital gain + 1.5% deferred capital gain. After-tax investment income earned in the corporate portfolio are retained in the corporation until distributed to the individual shareholder as a non-eligible dividend at the end of year 15. Dividend refunds are received in year 15 and are included in the dividend distributed in year 15 to individual shareholders (corporate portfolio). All taxable dividends paid to individual shareholders are non-eligible.

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Other key considerations

In addition to your investment strategy and tax rates during your working and retirement years, there are other factors that impact the RRSP vs. TFSA vs. Corporate investing decision. The following is a summary of those factors.

Desire for CPP/QPP benefits in retirement

The CPP/QPP retirement benefit is dependent on CPP contributions made. Those contributions are based on salary and bonuses paid to you during your working career. Dividends are not contributory earnings. Therefore, if you have a strong propensity to receive CPP retirement benefits, you may prefer to invest in your RRSP or TFSA as opposed to your corporation, all else being equal. Keep in mind that, as an incorporated business owner, you are required to remit both the employer and employee premiums whereby under phase I of the new CPP regime premiums are set to increase gradually from 2019 to 2023. The analysis above does not factor the CPP premium payment (and thus potential future CPP benefit) from the decision to pay a salary and make an RRSP contribution.

Lifetime Capital Gains Exemption (LCGE)

Accumulating excessive passive assets in a corporation may disqualify you from claiming the LCGE upon the sale (or deemed sale) of your shares. Without proper planning, saving too much in your corporation may jeopardize this important tax benefit, and therefore must be factored into the RRSP vs. TFSA vs. corporate investing decision (more on the LCGE below).

Suitability for Individual Pension Plans (IPPs)

In certain cases, IPPs may provide higher retirement benefits than what RRSPs can offer to you, as an incorporated business owner. There must be a history of T4 earnings and RRSP contributions in order to benefit from an IPP later in life. The suitability of an IPP as part of your retirement plan may play a role in choosing whether to save through an RRSP vs. TFSA vs. a corporation.

Changing tax rates

The assumption in Michelle's example is that she was in the top marginal tax bracket (for Ontario) during her working life, as well as in retirement. The decision of whether to choose an RRSP vs. TFSA vs. corporation will largely depend on current tax rates (high or low), and how those tax rates change over the course of your lifetime, as well as your expected tax rate in retirement.

Income splitting

Payments to family members in lower tax brackets allows a tax efficient way to draw money from the corporation and into the hands of family members. To the extent you can take advantage of income sprinkling (in light of the new rules) you may decide to forgo the corporate investing strategy, and utilize personal savings vehicles, such as the RRSP, TFSA as well as non-registered plans for retirement planning.

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Small business limit reduction

One of the drawbacks to corporate investing is that as passive assets grow, the amount of passive investment income may also grow. New rules (outlined in Part 2) effective for taxation years starting in 2019, may impact the corporation's ability to access some or all of the SBL when passive income exceeds $50,000. The new rules on passive investing may, in certain situations, provide an incentive to instead pay a reasonable salary/bonus from the corporation to save for retirement through the RRSP or TFSA, as a means of accessing the SBL.

Time horizon

The investment time horizon may also play a role in choosing the RRSP, TFSA or corporation. All else being equal, the more tax efficient your investment strategy (i.e., deferred capital gains) and the longer your time horizon, the more you may be able to accumulate in your corporation. The less tax efficient your investment strategy, the more attractive your RRSP and TFSA may be over the long term due to the tax preferences available with your RRSP and TFSA.

The purpose of this analysis is to highlight some of the key factors in making the best decision possible. The effectiveness of this strategy will differ between each incorporated business owner based on the factors outlined above (and more!). **Working with a qualified tax accountant and financial advisor is critical in determining the most suitable option for your personal circumstances.** Regardless of whether an RRSP, TFSA or corporate investing is best for you, Mackenzie Investments provides investment solutions that are designed to assist in helping investors to reach their retirement goals.

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Lifetime Capital Gains Exemption

Canadian individual taxpayers (not corporations) are entitled to a $892,218 (2021 and indexed for inflation annually) Lifetime Capital Gains Exemption (LCGE) on the sale of Qualified Small Business Corporation (QSBC) shares, and up to $1,000,000 exemption on the sale of qualified farm or fishing properties (qualified properties). The LCGE effectively shelters capital gains (up to the threshold) from tax when qualified property is sold.

Qualified farm or fishing properties can include assets such as real estate and eligible capital properties (e.g., milk and egg quotas) whether held in a sole proprietorship, partnership or corporation. Other than these specific assets utilized by qualified farm or fishing properties, the LCGE is only accessible on the sale of QSBC shares and not underlying corporate assets.

For individual QSBC shareholders, the LCGE can only be accessed when the shares are sold and the three following conditions are met:

- **At the time of sale/date of death,** at least 90% of the business' assets are used primarily in an active business in Canada
- **In the 24-month period prior to sale/date of death,** the shares were owned by the individual seller or a related person
- **In the 24 months prior to sale/date of death,** more than 50% of the active assets FMV were used in an active business in Canada

Assets used to earn passive (i.e., investment or rental) income generally do not satisfy the above criteria because they would not be considered to be used in an active business. For this reason, many business owners consider "purification" strategies (more on this below). This way, shares of an active business can remain eligible for the LCGE. It is also possible to multiply the exemption where family members (e.g., spouse and children) are shareholders of the corporation whether the shares are held directly or indirectly through a family trust. Potentially, this may be a valid strategy even if the child is a minor or not involved in the business.

Alternative Minimum Tax

Generally, when a preferential tax deduction such as the LCGE is claimed, alternative minimum tax (AMT) could apply, resulting in paying a higher amount of tax than expected. Basically, two tax calculations are performed. The first is the traditional tax calculation taking the LCGE into account. This number is then compared to a second calculation (i.e., AMT), where tax preferences such as the LCGE are not claimed, however a lower tax rate is applied. A taxpayer is subject to AMT when the second calculation is higher than the tax calculated under normal circumstances. The difference between the regular taxes owing and the second calculation is AMT. AMT is designed to prevent excessive tax deductions in any given year and may be viewed as a prepayment of future tax. The good news is that AMT is recoverable. That is, over the following seven years, AMT can be recovered by applying this amount against regular taxes owing. Many individuals who claim the LCGE may be surprised to find out that AMT may apply in the year of the LCGE claim.

AMT example:

Toni sells her qualified shares and triggers a capital gain of $1,000,000 and can claim the LCGE. Assume Toni is taxed at the top rate in Ontario at 53.53%.

	Regular tax	AMT
Taxable capital gain	$500,000	$500,000
LCGE	($446,109)	($446,109)
Taxable income	$53,891	$53,891
60% of non-taxable capital gain		$300,000
AMT exemption	–	($40,000)
(Adjusted) taxable income	$53,891	$313,891
Tax payable	$28,848	$62,937
Federal AMT (15%)		$47,084
Ontario AMT (33.67% of Federal AMT)		$15,853

The difference between AMT and traditional tax is equal to $34,089. This amount includes Federal and Ontario AMT and can be recovered over the next 7 years to the extent that regular tax exceeds AMT carryforward.

AMT can be reduced if Toni considered the capital gains reserve before entering into the transaction. This would allow the capital gain to be included in income over a maximum 5-year period provided the proceeds are equally received over the same time (or more).

Preservation of the Lifetime Capital Gains Exemption

Where an active business accumulates significant assets that are not being used to earn ABI (passive assets), the shares may not qualify for the LCGE when sold. If passive assets exceed 10% of total assets, the shareholders should consider strategies, so the exemption may be available in the future.

Purification strategies

To access the LCGE on a future share sale, the following purification strategies may be considered:

Excess cash can be used to pay down debt, shareholder loans or to purchase active business assets.

Consider paying a tax-free capital dividend to the shareholder, thus reducing excess cash in the company.

Consider a family trust to hold shares of the operating company. The trust can allocate a dividend paid from the company to a corporate beneficiary. This shifts excess assets out of the operating company, so the shares could potentially qualify.

Consider transferring the operating company's (Opco) value in excess of the LCGE to a new company (Holdco). This can help the business owner access the LCGE while excess assets can be transferred out of Opco so the shares qualify for the exemption. These are complex strategies that should be discussed with a tax professional.

Example:

Toni owns a small car detailing shop and only requires roughly $200,000 to maintain business operations, therefore at this time the company's shares would not qualify for the LCGE as only 20% of the fair market value assets are used in an active business (see below). Also, Toni is hoping to automate the business and plans on purchasing a piece of equipment worth $200,000. Let's see how the assets and liabilities can be reorganized so the exemption will be available to Toni in the future.

Current balance sheet	
Cash	$1,000,000
Liabilities and shareholders equity	
Shareholder loan	$200,000
Bank loan	$400,000
Retained earnings	$400,000
Total liabilities and shareholders equity	$1,000,000

With the excess cash, Toni can consider purchasing the piece of equipment for $200,000 and pay off the shareholder and bank loan.

Revised balance sheet	
Cash	$200,000
Equipment	$200,000
Total Assets	$400,000*
Shareholders equity	$400,000

*100% used in the active business

After the internal reorganization, 100% of assets are being used in the active business. Ongoing purification strategies will assist in meeting the exemption criteria so the LCGE is available in the future.

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Other benefits of holding companies

1 Creditor protection

It is not unusual for businesses to protect assets from potential creditors. Typically, an operating company earning ABI can accumulate substantial assets in the corporation. Where this is the case, they should consider how to protect assets from potential creditors.

A possible strategy involves transferring excess retained earnings to Holdco by way of an inter-corporate dividend. Holdco can lend the funds back to Opco on a secured basis. Also, significant assets such as real estate or investment portfolios may benefit from being held in a Holdco rather than the operating company in case of future litigation. These are complex strategies that should be discussed with a tax professional. The easiest solution to deal with potential creditors may be to purchase additional insurance within Opco.

2 Control over cash management

Where there are multiple shareholders of an Opco, it can be difficult for individual shareholders to clearly identify their portion of retained earnings. Individuals can hold their shares of Opco through a Holdco allowing individual shareholders to access their respective asset allocation from the Opco indirectly through their respective Holdco's. Additionally, this allows greater flexibility for individual shareholders, over the timing of taxable distributions and cash management as the funds may be retained in the company without incurring tax at the personal level. This can help preserve income sensitive benefits such as Old Age Security and potential conflict with other shareholders regarding management of allocated earnings.

Individuals can hold their shares of Opco through a Holdco allowing individual shareholders to access their respective asset allocation from the Opco indirectly through their respective Holdco's.

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What should happen to my business when I retire?

The answer usually depends on your specific situation. Common exit strategies generally include the following, each of which has advantages and disadvantages that can impact retirement.

1 Transfer/sell the business to family members

Transferring a company to family members (i.e., children) is an obvious succession plan for many business owners, but it is not always straightforward. Sometimes children have views that differ greatly from their parents, and in some cases, children have no interest in taking over the family business. It is important to assess the interest of children in advance as well as their ability to succeed you in running your business. Consideration should also be given to when and how the business should be divided amongst multiple children. It might make sense to transfer the business tax efficiently to children who are actively involved while leaving other personal assets to children who are not involved, allowing for a fair and efficient estate distribution. Implementing this strategy can provide the business owner a fixed income when redeeming freeze shares during retirement (More on this strategy in Part 4 of the Business Owner Kit).

2 Sell the business to a third party

A sale to non-family members or even employees can be an effective succession plan, particularly if family members are not interested or capable of continuing the business. A third-party sale usually allows business owners to maximize the return on their business and can be an effective way to make use of the LCGE on sale of QSBC shares.

3 Split business divisions

Often times several businesses operate in one corporation. Businesses that are involved in several different activities can result in simpler succession planning when transferring to multiple children. By dividing the business into separate divisions, business owners can deal with the issue of choosing between children by transferring to each child the division that is best suited to them.

4 Name an interim leader

Where family members (i.e., children) are not ready to succeed a retiring business owner, it might make sense to name an interim leader until the family member is prepared. An interim leader can serve as a mentor and keep the business going as your successor prepares. Ideally, interim leaders should have strong leadership abilities and a willingness to step aside when the time comes. They would likely need to be well compensated for their efforts, particularly if they will not have an ownership stake in the business.

Can I pay myself a retiring allowance?

At retirement, incorporated business owners can receive a retiring allowance from their corporation provided their employment relationship with the company ceases and the payment is "reasonable" (their relationship as a shareholder can remain). Reasonableness is generally determined based on the business owner's length of service with the company, the amount of remuneration received over the years and the value of pension and other retirement benefits to which the owner is entitled.

Retiring allowance payments are particularly beneficial where business owners have been active in their business before 1996. Where this is the case, provided the business owner is age 71 or younger, up to $2,000 per year of service prior to 1996 can be transferred to the business owner's RRSP without requiring RRSP contribution room. In addition, if the business owner is not entitled to company-funded pension or DPSP benefits, an additional $1,500 per year of service prior to 1989 can also be transferred. The transferrable portion of a retiring allowance payment (i.e., the amount that can be transferred to an RRSP without requiring RRSP contribution room) is referred to as the "eligible" portion of the payment. Amounts in excess of the eligible portion are referred to as "non-eligible" payments.

Retiring allowance payments are tax-deductible to the business and, unless transferred or contributed to an RRSP, taxable to the recipient. Retiring allowance payments can also be paid in instalments which can help the cash flow position of the corporation and defer personal income taxation to the business owner.

Example:

Holly wants to retire and is considering the sale of her incorporated business to a competitor.

In considering the sale, Holly realized that capital gains on sale would exceed her available LCGE, meaning tax payable at the time of sale. Wanting to defer a portion of her tax liability, Holly arranged for her corporation to pay her a $100,000 retiring allowance in respect of long employment with the company.

By paying the retiring allowance, Holly's corporation is entitled to deduct the payment, thus reducing its value, sale price and tax payable in the year of sale. Also, assuming Holly's business was established in 1985, $28,000 of the payment can be transferred to her RRSP without requiring RRSP contribution room (the "eligible" portion) deferring personal tax on this payment – Holly did not participate in a company pension plan while running the company, thereby increasing the eligible portion of her payment. The excess amount is taxable unless it can be sheltered in Holly's RRSP, provided she has available RRSP contribution room.

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Other retirement strategies

The following are some strategies incorporated business owners may consider in planning for retirement

Postpone the beginning of OAS benefits and CPP/QPP retirement pension

If the business owner does not require cash flow to fund retirement expenses, they may consider deferring OAS benefits and CPP/QPP retirement pension beyond age 65, to age 70 at the latest. Since July 2013, Canadians can choose to defer receiving OAS benefits beyond age 65. Deferring the pension allows for increased benefits. For every month beyond age 65 that the benefit is deferred, the OAS benefit increases by 0.6%. By deferring OAS by the full 5 years, the maximum OAS benefit would increase by 36% per year at age 70. In addition, for business owners still working and earning incomes in excess of approximately $80,000 (2021), deferring OAS may limit the impact of OAS clawback, to a later date when the business owner is potentially in a lower tax bracket. This strategy may help a business owner align more closely the time they begin receiving OAS benefits to a time when they might be ready to retire (i.e., reduce income levels).

Split pension income

Business owners can take advantage of pension income splitting to shift income from the high-income earning individual to their spouse or common law partner (CLP).

Individuals who are 65 years of age or older can allocate up to a maximum 50% of their eligible pension income received from a lifetime annuity, registered pension plan (RPP), registered retirement income fund (RRIF), life income fund (LIF) or deferred profit-sharing plan income (DPSP). While the pensioner is required to be age 65, the recipient spouse or CLP does not need to be 65 years of age or older to receive an allocation. The amount allocated to the spouse/CLP can vary year to year, and will depend on a number of factors, including income levels for each respective year.

Retirees under 65 can allocate up to 50% of an annual eligible pension income to their spouse/CLP. Eligible pension income includes benefits from an RPP, income from a DPSP or annuity received as result of the death of a spouse/CLP. RRIF or LIF income is not eligible pension income while the annuitant is under age 65, unless the individual is receiving the RRIF or LIF income due to the death of their spouse/CLP. At the Quebec tax level, an individual may not split any retirement income before 65 years of age.

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Claim the pension income amount

If a retiree decides to split eligible pension income with a spouse or CLP, they may be able to each claim the pension income amount, as a non-refundable tax credit provided the retirees are at least age 65. In Quebec, an amount for retirement income can also be claimed.

Income splitting with your company in retirement

New rules effective January 1, 2018 will apply top rate taxation, known as Tax on Split Income (TOSI) on certain payments made from a company to adult family members. These new rules now make it more challenging for incorporated business owners to income split with their families. There are however, a number of “exclusions” from the TOSI rules where if certain conditions are met, payments can be made to adult family members, where the taxes may be paid at the (presumably) lower tax rate of the family member. One of the exclusions for incorporated business owners entering retirement, is known as the “retirement exclusion”. Specifically, the TOSI rules will not apply to income received by an individual from a business if the individual’s spouse made contributions to the business and has attained age 65 in, or before the year the amounts are received. Furthermore, in the case of death, the surviving spouse/CLP will continue to benefit from the contributions made by the deceased individual. Therefore, if you are a business owner and currently meet one of the TOSI exclusions by virtue of your contributions to the business, then upon reaching age 65, payments (i.e., dividends) can be paid to your spouse/CLP without worry of the TOSI rules applying, regardless whether your spouse/CLP was actively involved in the business (i.e., payments made to a non-active spouse prior to you reaching age 65 would be subject to TOSI).

Share the QPP and CPP benefits

Under certain conditions, QPP and CPP benefits can be shared between spouse/CLP. Again, this may be beneficial where one spouse/CLP is in a lower tax bracket than the other.

Other cash flow options

Incorporated business owners do not always have to sell their company to receive cash flow in retirement. Those who wish to remain engaged in some capacity (i.e., while a child is transitioning to a new leadership role) can continue to receive a salary/bonus income from their company provided the payments are reasonable for work performed. Also, incorporated business owners can remain shareholders by receiving fixed value preferred shares as part of an estate freeze. Once implemented, the future value of the company accrues to the next generation. This allows the business owner access to a steady dividend income when the shares are redeemed during retirement years (more on this in Part 4).

Other possible options include the payment of tax-free capital dividends when corporations have a positive capital dividend account (CDA) or receive a return of capital where business owners have personally invested in incorporated businesses. An arrangement can also be made to have a corporation buy back a business owner’s shares over time, an option that would normally be taxed as a dividend.

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LCGE & AMT
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Retirement
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Retirement strategies

Plan in advance

At some point, every business owner will exit their business, or at least plan for post mortem (discussed in Part 5). Those who plan in advance will have the greatest opportunity to maximize their assets at retirement and maximize assets available to heirs at death. When considering a retirement plan, keep in mind that no one solution works for all situations. Family dynamics, taxation and cash flow needs all play a role in defining the most suitable plan. It is important for business owners to work with financial, tax and legal professionals well in advance of retirement to allow the time needed to identify, build and carry out an effective tax-efficient retirement plan.

Advisors

Investors

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General Inquiries

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