

# RRSPs and TFSAs for small business owners

As a small business owner, your corporation may produce surplus above what you need for your business or personal lifestyle. If you want to save the surplus for future use, you have options available. You can either retain it in the corporation or remove and invest personally. This article compares retaining the surplus in your corporation to removing and investing in a registered retirement savings plan (RRSP). We also review if the analysis changes when you want to save in your tax-free savings account (TFSA). As seen below, maximizing your RRSPs makes sense for most business owners given a sufficient time horizon. Maximizing your TFSAs has more considerations as shown below.

## The potential tax deferral

Many small businesses in Canada benefit from low tax rates on active business income (the “general rate”). The combined federal and provincial/territorial general rate ranges from 23%-30% across Canada. There is a further reduction known as the small business deduction up to a threshold (the “small business rate”). The combined federal and provincial/territorial small business rates range from 9%-12.20% on the first \$500,000. Some provinces also provide their lower rate up to a higher threshold.

Your personal tax rates can exceed both corporate active business income tax rates in many cases. For ordinary income, the highest combined marginal tax rates average above 50% across Canada. For dividends, the highest combined rates are approximately 28%-46% for eligible dividends and 37%-50% for non-eligible dividends. The lower personal tax rates on these dividends reflects the corporate tax already paid. Eligible dividends reflect the general rate, and non-eligible dividends reflect the small business rate already paid by your corporation.

Upfront, the lower corporate tax rates suggest there is a tax deferral for retaining funds inside your corporation. However, this does not automatically result in a deferral advantage. As seen below, your RRSP will initially have more invested when compared to corporate investing. Your TFSA will initially have less invested when compared to corporate investing. Regardless, having more (or less) invested upfront does not always result in more when you withdraw the funds as the tax consequences on withdrawal differ. The goal is to have more after-tax to you personally when you choose to liquidate the investment and distribute proceeds. Key items that influence the analysis include:

- Your corporation’s initial tax rate on active business income (general or small business rate).
- If you’re in the same, lower, or higher tax bracket when you invest compared to when you liquidate the investment.
- The form of investment income generated (interest, dividends, capital gains, or deferred gains).
- Time horizon (the length of time the funds stay invested).

## Investment vehicle characteristics

Below is a summary of the tax differences between removing and investing in your RRSP/TFSA and retaining inside your corporation.

	RRSP	TFSA	Corporate
<b>Tax prior to investing</b>	Tax deferred - deductible for your corporation when paid as salary and deductible for you when contributed to your RRSP	Corporate tax on business income if you take a dividend (none if paid a salary). Personal tax to receive funds from corporation as either salary or dividend	Corporate tax on business income at the general rate or small business rate (depending on total corporate income)
<b>Tax on growth while invested</b>	Tax deferred	Tax free	Your corporation pays tax depending on the type of income: <ul style="list-style-type: none"> <li>• Interest (46.67%-53.67%), taxable Canadian dividends (38.33%) and capital gains taxed as passive investment income.</li> <li>• Tax on capital gains is 50% of the above rate on interest. The non-taxable portion credits the notional capital dividend account (CDA).</li> <li>• Passive investment tax generates a credit to notional accounts known as the refundable dividend tax on hand (RDTOH). Your corporation recoups this when it pays taxable dividends to you as shareholder.</li> </ul>

	RRSP	TFSA	Corporate
<b>Tax inside the vehicle upon disposition</b>	Tax deferred	Tax free	Capital gains taxed as passive investment income inside the corporation when you liquidate or rebalance the investment (see above).
<b>Personal tax on removal</b>	Fully taxable as ordinary income	Tax free	Your corporation can pay dividends to you as follows: <ul style="list-style-type: none"> <li>• Tax-free capital dividends up to the CDA balance; and</li> <li>• Taxable eligible and non-eligible dividends. Dividends are grossed up (15% for non-eligible and 38% for eligible) on your personal tax return and a dividend tax credit applied. Paying taxable dividends allows your corporation to recoup RDTOH previously paid.</li> </ul>
<b>Contribution limits</b>	18% of earned income up to a maximum of \$32,490 (2025)	\$7,000 (2025) Cumulative limit of \$102,000 (assuming you've been a resident of Canada over 18 since 2009).	N/A
<b>Age limits</b>	Must convert to income stream at the end of the year in which you turn 71	Contribution room accrues only to those 18 and older resident in Canada.	N/A

This leads to the first question. **Does the tax deferral inside the RRSP result in more after-tax to you when you liquidate the investment and distribute the proceeds?**

## Comparing the options

We'll analyse Andre's situation, a resident of Ontario at the highest tax bracket because of his \$300,000 salary. His corporation is also resident in Ontario and has \$10,000 before-tax surplus.

If Andre's corporation pays him additional salary, it deducts \$10,000 from the corporation's pre-tax profits (reducing it to nil). Andre receives the \$10,000 and contributes the entire amount to an RRSP. The result - Andre invests \$10,000 in an RRSP.

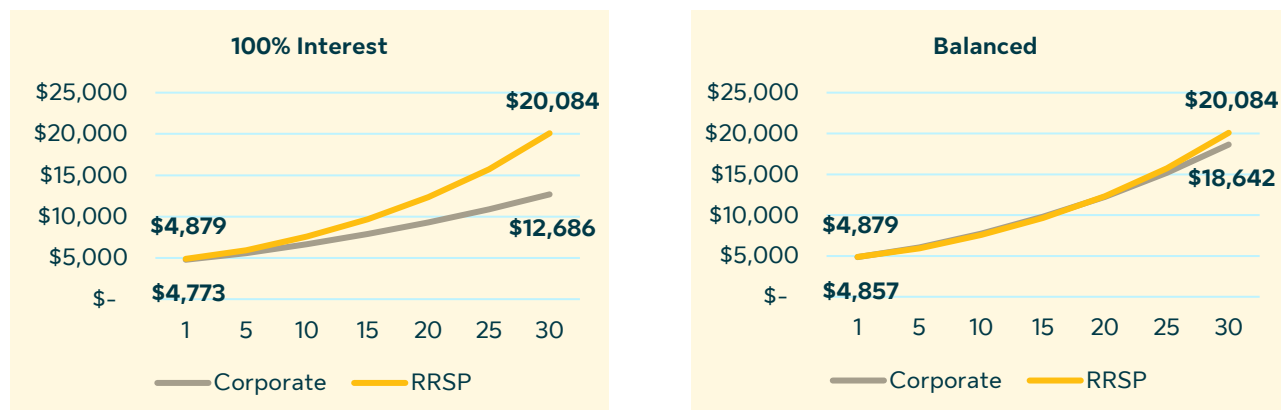
If Andre's corporation retains the surplus, the after-tax amount available to invest depends on the corporation's tax rate:

- **Small business rate.** The \$10,000 profit has 12.2% corporate taxes, leaving \$8,780 available to invest.
- **General rate.** The \$10,000 profit has 26.5% corporate taxes leaving \$7,350 available to invest.

The corporation then invests the after-tax amount subject to corporate investment tax rates as explained above.

To compare apples to apples, Andre invests the available amount in the same investment either inside the corporation or RRSP. We'll review both a 100% interest portfolio and a hypothetical balanced portfolio earning 5% annually (equally divided between interest, dividends, capital gains and deferred gains). To make it a fair comparison, we need to look at the after-tax value of each option to Andre personally. So, we need to collapse the RRSP and remove the funds from the corporation.

**At small business rates initially, the after-tax amount available to Andre over time is as follows:**



When the corporation initially pays tax at the small business rate, the RRSP begins to outperform right from the beginning. In both cases, although the RRSP starts higher, it takes time to produce a difference of more than 1%. You'll notice the balanced portfolio takes more time for the RRSP to significantly outperform. This reflects the lower corporate tax rate on dividends and capital gains.

Keep in mind, the lower your interest income inside your corporation, the better the corporate investment performs. However, your type of investment should meet your risk tolerance. We don't recommend choosing investments outside of your risk tolerance solely to produce a better tax result. Corporate class mutual funds can reduce interest-producing investments, although distributions on such investments may vary. Consult your financial advisor to review your risk tolerance and investment objectives prior to choosing your type of investment.

Now let's look at how the same investment performs across Canada at different tax rates. In all cases, we're looking for the time it takes the RRSP to outperform the corporate investment by 1%.

### If you're in the same tax bracket when removing the funds

Below is a summary of the time needed across Canada for the RRSP to outperform the corporate investment. In all cases, we assume you remain in the same tax bracket throughout your lifetime. We display the time needed assuming you're at the second federal tax bracket (around \$57,000), third federal tax bracket (around \$114,000), or the highest tax bracket (around \$253,000+) during your lifetime.

#### Small business rates initially – years needed for RRSP to outperform corporate investment by 1%+

	100% interest portfolio			Balanced portfolio		
	Second tax bracket	Third tax bracket	Highest tax bracket	Second tax bracket	Third tax bracket	Highest tax bracket
BC	1	1	1	5	11	22
AB	2	2	1	9	11	18
SK	3	3	3	12	14	20
MB	2	1	1	9	13	18
ON	1	1	1	6	13	21
QC	1	1	1	1	9	17
NB	2	2	2	10	14	21
NS	1	1	1	7	10	19
PEI	1	1	1	7	12	18
NL	2	2	2	8	11	19
YT	2	1	1	8	11	18
NWT	6	7	7	14	19	24
NU	1	1	1	4	5	10

When your corporation initially pays tax at small business rates, the RRSP generally provides more after-tax over time. The lower the amount of interest income, the better the corporate investment performs. However, even the balanced portfolio outperforms in the RRSP over time.

### If your corporation pays tax at the general rate

If your corporation initially pays tax at the higher general tax rate, it takes even less time for the RRSP to outperform. Only BC, NB, YT, and NWT need more than 1 year at the top marginal tax bracket. Even then, it only takes a maximum of 3-7 years. **So, investing in an RRSP makes sense for most if your corporation pays tax at the general rate.**

### If you're in a lower tax bracket when removing the funds

Not everyone stays at the same tax bracket during their lifetime. You may drop tax brackets from when you invest the funds to when you remove the funds. As you drop tax brackets, the time needed for the RRSP to outperform decreases. The more tax brackets you drop when you remove the funds, the less time the RRSP needs to outperform. **So, RRSPs make even more sense if you expect to drop tax brackets in the future.**

### If you're in a higher tax bracket when removing the funds

You may also increase tax brackets from when you invest to when you remove the funds. As you increase tax brackets, the time needed for the RRSP to outperform the corporate investment increases. However, the time shown on the "highest tax bracket" column is the upper limit needed for that form of investment. **So, given sufficient time, investing in an RRSP likely makes sense.**

## How does it differ if you want to remove surplus corporate funds to invest in a TFSA?

Unlike RRSPs which benefit from an upfront deferral, both your TFSA and corporate investment start with after-tax money. However, your TFSA starts with after-tax personal money and your corporate investment starts with after-tax corporate money. The difference between the higher personal tax rates and lower corporate tax rates may result in a tax deferral. If the corporate tax rate is lower than your personal tax rate, you have more after-tax to invest in your corporation. Across Canada, the potential deferral ranges from 32.5%-43.3% for corporate income taxed at the small business rate. The deferral is approximately 17.5%-27% for corporate income taxed at the general rate. To calculate your potential deferral, subtract your corporation's tax rate from your current personal tax rate.

**Does the corporate tax deferral offset tax-free growth in the TFSA to provide more after-tax to you when you liquidate the investment and distribute the proceeds?**

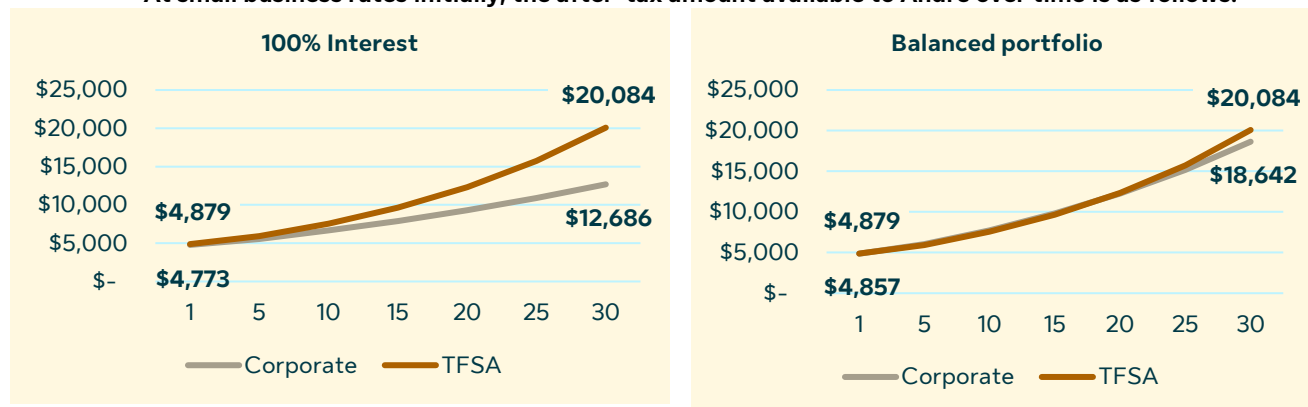
### Revisiting Andre

If Andre's corporation pays him a salary, it deducts \$10,000 from the corporation's pre-tax profits (reducing it to nil). Andre receives the \$10,000 and pays tax at his tax rate of 53.53%. The result - Andre invests \$4,647 in a TFSA. The corporate investment will perform the same as above.

### If you're in the same tax bracket when removing the funds

To compare apples to apples, Andre will invest the after-tax amount in the same investment either inside the corporation or TFSA. We'll review both a 100% interest portfolio and hypothetical balanced portfolio earning 5% annually (equally dividend between interest, dividends, capital gains, and deferred gains). To make it a fair comparison, we need to look at the after-tax value of each option to Andre personally. Therefore, we need to remove the funds from the TFSA and corporation.

**At small business rates initially, the after-tax amount available to Andre over time is as follows:**



When the corporation initially pays tax at the small business rate, the TFSA begins to outperform right from the beginning in both cases.

How does that compare to investing in RRSPs? You might notice the above charts are identical to those in our RRSP analysis. This is because, if you remain in the same tax bracket, the time you need for the TFSA to outperform the corporate investment mirrors RRSPs. In fact, the TFSA and the RRSP will provide you with the same amount after-tax when liquidated if you remain in the same tax bracket during your lifetime. This makes sense because RRSP and TFSA money are both only taxed at one point and your tax rate remains unchanged.

In fact, the times shown above for each province and tax bracket are identical for the TFSA to outperform the corporate investment. There is one major difference though. Many use their TFSAs for short-term investing purposes. Therefore, if you intend to use the TFSA for shorter-term investment, you may not end up with more money after tax compared to retaining inside the corporation for that short time. Consult the above charts against your intended timeline.

### If your corporation pays tax at the general rate

If your corporation initially pays tax at the higher general tax rate, it takes even less time for the TFSA to outperform. Only BC, NB, YT, and NWT need more than 1 year at the top marginal tax bracket. Even then, it only takes a maximum of 7 years. **So, investing in an TFSA makes sense for most if your corporation pays tax at the general rate.**

### If you're in a lower tax bracket when removing the funds

Like the RRSP analysis, not everyone stays at the same tax bracket during their lifetime. You may drop tax brackets from when you invest the funds to when you remove the funds. Unlike the RRSP analysis though, if you drop tax brackets between now and when you liquidate the funds, the TFSA takes more time to outperform. In this case, the corporate tax deferral

becomes more relevant. That is, you remove money initially from your corporation at a higher tax rate to invest in a TFSA. However, you remove corporate money later at a lower tax rate.

- When your corporation initially pays tax at the small business rate, the TFSA typically needs significant time to outperform the corporate investment for both portfolios. This makes sense because at small business rates, the corporate tax deferral advantage is larger. **Across Canada, the TFSA needs between 23 and 30+ years to outperform the corporate investment by 1%.** The more tax brackets you drop when you remove the funds, the more time the TFSA needs to outperform.
- When your corporation initially pays tax at the general rate, the TFSA takes less time to outperform than at the small business rate. This makes sense because the corporate tax deferral advantage is smaller. However, in many cases, the TFSA still requires significant time to outperform the corporate tax deferral. **In most cases it takes an average 20+ years for the TFSA to outperform by more than 1%.** The more tax brackets you drop when you remove the funds, the more time the TFSA needs to outperform.

Even if you aren't in the highest tax bracket when you invest the funds, the TFSA needs time to outperform. **So, if you expect to be in lower tax bracket in when you remove the funds, the TFSA may not outperform the corporate deferral.**

### If you're in a higher tax bracket when removing the funds

You may also increase tax brackets from when you invest to when you remove the funds. In this case, the TFSA tax-free growth becomes more relevant. This is because you initially remove money from your corporation at a lower tax rate to invest in a TFSA and then it continues to be tax free. However, you later remove the corporate investment at a higher tax rate. In all cases, the TFSA outperforms right from the beginning and continues to outperform significantly. This is true whether your corporation initially pays tax at small business or general corporate rate. **So, if you expect to increase tax brackets, removing funds to invest in your TFSA makes sense.**

### Other considerations

In addition to the above, keep in mind the following considerations:

- Goal for the investment (short term versus long term). Although RRSPs are a long-term retirement investment vehicle, TFSAs are not always the same. Many use a TFSA for short-term goals and needs. As such, your goal and objective relating to the TFSA will be key.
- Loss of income tested benefits in retirement. Grossed up dividends and RRSP withdrawals increase net income, but TFSA withdrawals do not.
- Creditor protection. Corporate funds and TFSAs may be exposed to creditors whereas RRSPs benefit from Federal bankruptcy protection and general creditor protection in some provinces.
- Eligible pension income splitting rules for RRSPs compared to tax on split income rules for corporate funds.
- Flexibility to determine income. RRSPs have forced income after age 71.
- The "use it or lose it" function of TFSA. The value accumulated in your TFSA can retain its tax-free status when you name a spouse as successor holder or beneficiary upon your death. However, you can only contribute to your TFSA while alive. You cannot contribute to them posthumously and your estate cannot make spousal contributions like with spousal RRSPs. As such, if you do not contribute to a TFSA during your lifetime, you lose the contribution room upon your death.
- Loss of low small business rate when accumulating passive income inside your corporation.
- Corporate structure and complexity and cost of post-mortem planning when retaining funds inside your corporation.
- Need to recoup RDTOH built up inside the corporation.

### The bottom line

Saving for future income needs requires you to plan and weigh the options available to you. Since RRSPs are a long-term retirement investment vehicle, removing corporate funds to invest in RRSPs makes sense for many. The TFSA will outperform in many cases given sufficient time except when you decrease tax brackets upon removing the funds. However, there is no one size fits all solution. It depends on corporate tax rates, personal tax rates (now and in the future) and timing for the funds. Use the above as a guideline to make an informed decision particular to your stated goals and objectives.

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