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Should Mitra, 55, incorporate her successful consulting business?

DIANNE MALEY
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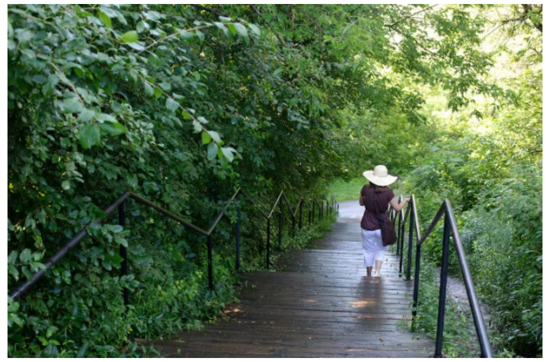

At age 55, with her consulting business growing, Mitra wonders if it makes sense for her to incorporate. Her revenue is $174,000 a year "trending toward $200,000," she writes in an e-mail. After business expenses and income tax, she nets about $122,200 a year.

"The thought is that if I incorporate and keep earnings in the business, I can pay it to myself later – from age 65 to 70 – as dividends and defer Canada Pension Plan benefits and RRSP withdrawals to stretch out retirement income," Mitra writes. "It would also allow me to better manage my personal income levels and subsequent taxation."

Mitra has a mortgage-free condo in the Toronto area, cash set aside for renovations, a new vehicle and an emergency fund, as well as registered savings.

"I love what I do so it is not a hardship to continue working to 65," Mitra adds. If she incorporates, should she pay herself dividends or a combination of dividends and income, she asks. Money retained in a corporation can be paid out entirely either as a dividend or income.

Another question is whether she should put off drawing from her registered retirement savings plan (RRSP) until she turns 71, the age limit for converting it to a registered retirement income fund (RRIF), and begin making minimum mandatory withdrawals at 72. "Or maybe I should draw down the RRSP sooner to minimize tax." Her retirement spending goal is $80,000 a year after tax.

"Is it really worthwhile to incorporate given my circumstances, or is it just six of one and half a dozen of another?"

We asked Ian Calvert, a certified financial planner and principal at HighView Financial Group in Toronto, to look at Mitra's situation.

WHAT THE EXPERT SAYS

Incorporating can provide several benefits, but the most impactful will be the ability to defer personal income taxation, Mr. Calvert says.

"For instance, while Mitra is operating as a sole proprietor, all earned income will be reported on her personal tax return each year," he says. "If she chooses to incorporate, she will only be taxed on what she extracts personally each year. This allows for greater control of her personal income as long as she generates more business income than she needs to pay for living expenses."

By changing the income from personal to corporate, the active business income will be to the corporate tax rates, which are generally lower than personal rates. "This can provide a meaningful advantage as long as the surplus funds stay in the corporation," the planner says.

If the corporation is considered a Canadian-controlled private corporation, she would also benefit from the small-business deduction, which lowers the federal income-tax rate on the first $500,000 of active income. "The result is the ability to be taxed less today and to have more after-tax income to accumulate for retirement," Mr. Calvert said.

This strategy works if you are starting to accumulate savings and investments within the corporation.

It should be noted that there are some disadvantages to incorporating, Mr. Calvert said. Incorporation will come with legal costs, continuing accounting costs to file corporate tax returns each year and other complexities.

If Mitra proceeded with incorporating, it would alter her balance sheet and the location of her investable wealth. For instance, with her gross business income, after paying her a $90,000 salary, business expenses and income taxes, she would retain about $50,000 in her corporation each year.

Then, if she started to build an investment portfolio with her corporate surplus, she could start accumulating meaningful wealth inside her corporation, the planner says. By age 65, she could expect to have the following assets: Her home valued at $1.2-million, a corporate portfolio of $715,000, an RRSP of $1.05-million and a tax-free savings account (TFSA) of $330,000.

This assumes she contributes $7,000 each year to her TFSA and $10,000 to her RRSP. Her RRSP contributions will be lower than they are now because her taxable income will be lower. It also assumes an average annual rate of return on her investments of 5 per cent, in line with Mitra's own target.

She'll be drawing money from her RRSP, TFSA and corporate investment account. "Withdrawals from an RRSP, a corporation, and a TFSA have very different tax consequences," he says. "Having many options increases her toolbox for cash flow and tax planning opportunities."

Mitra asks if continuing to contribute to her RRSP still makes sense. "An RRSP that gets too big can create longer-term tax problems, such as large taxable minimum withdrawal or funds left in the account upon passing," Mr. Calvert says. "An RRSP of $1,050,000 certainly could create a tax problem without a solid exit strategy."

In Mitra's case, following the minimum withdrawal schedule would not be advisable, he says. Rather than waiting until age 72 and taking only the minimum each year, she should do the complete opposite, the planner says. She should start early and withdraw much more than the minimum.

When Mitra retires at age 65, her RRSP should be utilized in the first year of low taxable income. Or in her case, the first year she stops paying herself a salary, he says.

With no income at age 65, and the goal of waiting to age 70 to receive enhanced Canada Pension Plan (CPP) and Old Age Security (OAS) benefits, Mitra could convert her RRSP to a RRIF and start a $100,000 withdrawal each year. "At this income level, she would owe an estimated $19,000 to $20,000 in tax, leaving her a net amount of $80,000 a year to fund her anticipated lifestyle needs," Mr. Calvert says.

This more aggressive RRIF withdrawal in the first five years would reduce her RRIF balance to $825,000 by age 70, he says. Once her CPP and OAS benefits start, she could then lower her annual RRIF withdrawal to about $50,000, which is slightly above the estimated minimum for her age and account size.

At age 70, phase two of her retirement cash flow plan would start, Mr. Calvert says. She could then have four sources of income: CPP, OAS, RRIF withdrawals and taxable dividends from her corporate account. This dividend income would be taxed more favourably than the RRIF withdrawals and government benefits because it would benefit from the dividend tax credit. "I estimate that she will need about $25,000 a year from her corporation on top of her RRIF and enhanced CPP and OAS, which are expected to be $20,600 and $16,000 per year with inflation," the planner says. This would provide a pretax income of about $112,000 a year.

Unlike her RRIF payments, which follow a prescribed withdrawal schedule, she could be in total control of her corporate withdrawals, increasing or decreasing the taxable dividends to meet her cash-flow needs, the planner says. At this rate of withdrawal from a healthy asset base, Mitra should consider either increasing her lifestyle spending or developing an estate plan for the surplus personal and corporate assets.

CLIENT SITUATION

The people: Mitra, age 55.

The problem: Whether to incorporate her successful consulting business. When and how to draw down her RRSP in the most tax-effective manner.

The plan: Incorporation makes sense as long as she has more income than she needs to cover her lifestyle spending. Draw down her RRSP savings when she retires and stop drawing a salary, likely at age 65. Draw dividends from her corporation as needed.

The payoff: A clear path forward.

Monthly net income: $10,185.

Assets: Cash and short-term deposits $194,950; guaranteed investment certificates $130,815; other non-registered accounts $12,000; woodlot/building lot $105,000; TFSA $141,450; RRSP $622,985; home $930,000. Total: $2.1-million.

Monthly outlays: Condo fees $745; property tax $290; garbage $25; home insurance $60; electricity $120; heating $85; maintenance, garden $120; transportation $265; groceries $600; clothing $220; gifts, charity $150; vacation, travel $600; dining, drinks, entertainment $280; personal care $65; pets $250; sports, hobbies, subscriptions $100; doctors, dentists, drugstore $160; health, dental insurance $335; disability, critical illness $285; phones $160; RRSP $2,420; TFSA $585. Total: $7,920.

Liabilities: None.

Ian Calvert is a Vice President & Principal at [HighView Financial Group](#).