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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

To incorporate or not

Is incorporating your business right for you?

Please contact us for more information about the topics discussed in this article.

As a sole proprietor, you may wonder whether to incorporate your business. While incorporating is good for some, not all businesses will benefit from a corporate structure. This article highlights some of the points you may consider when deciding whether to incorporate your business.

This article uses the terms “corporation” and “company” interchangeably to refer to a Canadian-controlled private corporation (CCPC). In simple terms, a CCPC is a Canadian corporation not controlled by a non-resident of Canada or by a public corporation, or a combination of both. In addition, no class of shares of a CCPC is listed on a designated stock exchange.

What is incorporation?

The act of incorporation creates a new legal entity separate from yourself. Your corporation will have certain rights and obligations, including the ability to acquire assets, obtain a loan, enter into contracts, incur legal liability, and carry on a business. Once you incorporate, the corporation’s assets belong to the corporation and not to its shareholders.

Advantages of incorporation

Tax deferral

One of the significant advantages of incorporation is the potential to defer income tax. Income earned and withdrawn from a corporation is taxed twice — once at the corporate level and once at the personal level when the funds are withdrawn. By earning income in your corporation and not

withdrawing the funds, you can defer the personal tax on the income until it’s withdrawn from your corporation. Generally, the longer you keep the funds in your corporation, the larger the tax deferral advantage will be.

This tax deferral is available because corporate tax rates on active business income (ABI) is generally lower than personal tax rates. ABI is generally income derived from performing an activity or operation to earn that income. It would not normally include passive investment income unless the investment income pertains to, or is incidental to, the income of the corporation from its active business. If your corporation earns ABI, the taxable portion (after eligible deductions) is subject to a general federal corporate flat tax rate

plus the applicable provincial or territorial corporate flat tax rate. Further, if your corporation is a CCPC throughout the tax year, it may benefit from the small business deduction (SBD), which lowers the federal corporate tax rate (known as the “small business tax rate”) considerably on the first \$500,000 of ABI (known as the “business limit”). Each province or territory also has a business limit that significantly lowers the corporate tax rate on the ABI up to the business limit.

A corporation must meet additional criteria to qualify for the Quebec SBD. Corporations will only qualify for the Quebec SBD if they operate in the manufacturing sector or primary industries, or where the corporation meets the minimum number of remunerated hours test.

As a result of lower corporate tax rates for ABI, if you incorporate your business, you may have more after-tax business income to invest inside your corporation. This allows for more funds to invest in and grow your business, or allows you to passively invest a larger amount, which may result in higher after-tax returns in your corporation than you can realize personally.

To limit this tax deferral advantage for large corporations or corporations that earn significant passive investment income, the Income Tax Act contains rules to restrict access to the SBD and the small business tax rate for certain CCPCs. The rules grind down the business limit available to a corporation by the greater of two reduction calculations: the reduction based on taxable capital employed in Canada and the reduction based on passive investment income. In addition, the business limit must be allocated and shared among your corporation and any associated corporations. The definition of association is complex and is beyond the scope of this article.

Reduction based on taxable capital

For corporations (and their associated corporations) that have taxable capital employed in Canada of more than \$10 million, the federal business limit is reduced on a straight-line basis and is eliminated when taxable capital is \$50 million or more.

Reduction based on passive investment income

A CCPC will have its federal business limit for the following taxation year reduced on a straight-line basis when the CCPC and its associated corporations earn more than \$50,000 of passive investment income in the year. The business limit is reduced by \$5 for every \$1 of passive investment income above the \$50,000 threshold. The business limit is eliminated when the CCPC and its associated corporations earn \$150,000 or more of passive investment income in a year. As such, to the extent your

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corporation, and any other associated corporations, are fully utilizing the \$500,000 business limit, you may want to ensure the passive investment income earned by your corporations don't grind down your business limit.

Most provinces and territories are aligned with the federal rules related to taxable capital and the grind to the business limit. The provincial or territorial business limit may also be reduced for CCPCs that have significant income from passive investments. Please confirm the specific rules of your province or territory of residence with a qualified tax advisor.

Income splitting opportunities

Incorporating your business may allow you to take advantage of income splitting opportunities. By having lower-income adult family members as shareholders, it may be possible for the corporation to pay them dividends to take advantage of their lower marginal tax rates. It's important to note there are “tax on split income” (TOSI) rules which limit the ability to split certain types of income with family members.

These TOSI rules apply to many types of income received from a private corporation, including interest, dividends, as well as certain capital gains, but they do not apply to reasonable salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal tax rate and the individual is unable to claim personal tax credits on that split income, except for the disability tax credit, dividend tax credit or foreign tax credit.

There are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults aged 18 to 24, and adults aged 25 and over. The exclusions mainly rely on whether the family member is significantly involved in the business or owns shares with a certain portion of the votes and value of the corporation. There's also an exclusion available to the spouse of a business owner who is age 65 or over. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask your RBC advisor for an article discussing income splitting through private corporations.

You can also split income with family members using other methods that don't require you to incorporate your business or add them as shareholders of your corporation. For example, you can have your corporation pay reasonable salaries to your family members for the services they provide. This strategy allows you to take advantage of your family members' lower marginal tax rates while generating registered retirement savings plan (RRSP) contribution room for them at the same time. A deduction may be claimed for any reasonable salaries paid.

The lifetime capital gains exemption (LCGE)

You may enjoy a significant tax break on the capital gain you realize on the disposition of certain private company shares. Each individual resident in Canada can claim an LCGE to shelter capital gains on the disposition of qualified small business corporation (QSBC) shares. Therefore, incorporating your business may enable you to sell your business and shelter from tax any growth in the value of your shares, up to the LCGE limit. Speak to a qualified tax advisor to determine the amount of LCGE that is available to you.

It may also be possible to multiply the LCGE available on the disposition of QSBC shares if you and other family members own shares of a qualifying corporation, directly or indirectly. Each family member has their own separate LCGE to shelter the capital gains allocated to them. Multiplication of LCGE may result in significant tax savings for your family. Please note that if you multiply the LCGE with your family, they are entitled to some of the proceeds of sale related to their shares. It's important this is your intention when contemplating such planning.

For more information about the types of shares that are QSBC shares, please ask your RBC advisor for an article on the capital gains exemption on private shares. Also speak to a qualified tax advisor if you're a sole proprietor and planning to sell your business, since you may be able to claim the LCGE by transferring all or substantially all of your business assets into a corporation and immediately selling the shares of the newly formed corporation.

Flexibility in remuneration

By incorporating your business, you gain the flexibility to use a combination of different forms of remuneration, including salaries, bonuses and dividends. The ability to choose the type and amount of remuneration may allow you to maximize tax deferral while still taking advantage of benefits such as creating RRSP contribution room and participating in the Canada Pension Plan or the Quebec Pension Plan.

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Flexibility in employee benefits

By incorporating your business, you gain access to certain types of employee benefits or retirement savings plans, such as an individual pension plan (IPP) and a retirement compensation arrangement (RCA) that would otherwise not be available if you were a sole proprietor or a partner in a partnership.

Implementing an IPP

An IPP is a defined benefit pension plan that a corporation can establish for its owner who also works in the business or key employees. An IPP may be suited for individuals over the age of 40 who earn a substantial amount of employment income. It's usually established for one individual, say, yourself as the business owner, but the benefits can be extended to your spouse and other family members if they're employed by your corporation. In certain situations, an IPP can provide greater annual contribution room than an RRSP.

Contributions to an IPP provide an immediate tax deduction to your company and are exempt from payroll and healthcare taxes. You will not pay personal tax on the contributions until you receive the benefit in a future year (potentially when you're in a lower tax bracket). In addition, you may be able to split your IPP retirement income with your spouse, which may further reduce your family's overall tax bill.

If you or your business runs into financial difficulty, the assets in the IPP are generally protected from creditors. This allows you to set aside a significant amount of tax-deferred income for your retirement while having the assets protected from corporate creditors. Speak with a qualified legal advisor before implementing any creditor protection strategies. For more information about an IPP, please ask your RBC advisor for an article on IPPs.

Implementing an RCA

An RCA can provide you with supplemental pension benefits so that you can maintain your standard of living in retirement. Typically, an RCA is part of a retirement plan, which can include a registered pension plan (RPP) such as an IPP set up by the company. An RCA can also provide pension benefits when a company doesn't have an RPP.

Contributions to an RCA provide an immediate tax deduction to your company and there's no upper limit on the amounts your company or the employee can contribute to the plan, provided the amounts are "reasonable." Keep in mind, contributions to an RCA (and any income or realized capital gains in the RCA) are subject to a 50% refundable tax. This means the amount of funds available for investment may be significantly less in the RCA than if the corporation keeps the funds to invest or contribute to an IPP.

You won't be taxed on the RCA contributions until you receive the benefit in a future year (potentially when you're in a lower tax bracket). In addition, you may be able to split your RCA income with your spouse in retirement, subject to a limit.

Like IPPs, RCAs may provide a level of protection from your business's creditors. Speak with a qualified legal advisor before implementing any creditor protection strategies.

Limited liability

Incorporation limits the liability of a corporation's shareholders. This means that, generally, the shareholders of a corporation are not responsible for the corporation's liabilities unless they've provided a personal guarantee. However, if a shareholder is also a director, that person could be liable for certain corporate liabilities (which may include unpaid wages and payroll taxes) in their role as a director.

Better access to capital

Raising money is often easier for corporations than for other forms of businesses. For example, corporations have the option of issuing bonds or share certificates to investors. As a sole proprietor, you may have to rely on your own money and your own ability to obtain loans for capital. This can limit the ability to expand your business.

Continuous existence

If you operate your business as a sole proprietorship or a partnership, your business ceases to exist on your death. On the other hand, your corporation would continue to exist even if every shareholder and director were to pass away. The ownership of the corporation could be transferred to your heirs on your passing. This greater permanency may allow you to plan for your corporation over a longer term.

Disadvantages of incorporation

While incorporating your business may provide certain advantages, you need to weigh these benefits against the potential disadvantages, such as the initial and ongoing accounting, administration, tax and legal costs. Some of the drawbacks are discussed in the following sections.

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Increased complexity and cost

A corporation is a separate legal entity and has no physical form. As such, the corporation needs individuals (such as shareholders, directors and officers) to carry out the business activities on its behalf. This business structure is more complex. In addition, operating your business through a corporation may require you to adhere to a number of corporate formalities. For example, regardless of whether you're the sole owner or one of many owners of your incorporated business, the directors of the corporation will still need to pass a resolution to declare and pay dividends.

A corporation is also subject to greater regulation and compliance than a sole proprietorship or partnership. For instance, your corporation will have to hold annual shareholder meetings and maintain corporate records. If there are any changes to the board of directors, your corporation will have to file notices with the government.

The administrative, legal and accounting costs associated with establishing and maintaining a corporation are also usually higher than those of a sole proprietorship or partnership. When setting up the corporation, the corporation must file certain documents with the government including articles of incorporation. If you ever make changes to the structure of your corporation, articles of amendment will need to be filed as well.

In terms of ongoing professional fees, your corporation will incur more costs to file an annual corporate tax return and T5 slips for dividends paid.

Restricted use of business losses

Generally, in the first few years of operation, a business may generate losses due to high start-up costs and/or the cost of building a sales base. As a sole proprietor, you may use any business losses to offset your personal income from other sources. However, once you have incorporated, any business losses realized in the corporation must be applied against corporate income and can't be used to offset personal income.

Whether you incur these losses as a sole proprietor or through your corporation, any business losses not used in the year they're realized can generally be carried

back three years and forward 20 years to use against income in those years.

Restricted personal use of corporate funds

All of the business income you earn annually as a sole proprietor is taxed in your hands. As such, you can use the after-tax profits however you wish. On the other hand, if you incorporate your business, the after-tax profits belong to the corporation, and you can't use the corporate funds for personal expenses unless you first withdraw the money from the corporation. Depending on how the funds are withdrawn from the corporation (e.g. as salary, bonus or dividend), you'll generally be subject to tax on the withdrawal.

Taxes at death

If you own shares of a private corporation, you may be subject to double taxation on your passing. First, you're taxed on the capital gain arising from the deemed disposition of your shares at death. Then, if the corporation is wound up or the corporation makes distributions to its shareholders, a second level of tax is triggered. Alternatively, if the shares of the corporation are redeemed by your estate or your beneficiaries, this may result in a taxable dividend.

It is possible to defer the tax on your shares by transferring them to a surviving spouse or qualifying spousal trust on a tax-deferred basis. There are also other post-mortem planning alternatives that may reduce or eliminate the potential for double taxation. For more information on strategies that reduce the double tax exposure on death, speak to a qualified tax advisor.

Employer health tax obligation

Corporations in several provinces have to pay a provincial health tax once the corporate payroll has exceeded a certain threshold. Speak to a qualified tax advisor about these obligations.

Should you incorporate?

After familiarizing yourself with some of the advantages and disadvantages of incorporating, here are some questions you can consider when deciding whether you should incorporate your business.

Do you need a substantial portion of your business income to fund your annual living expenses and meet your financial goals?

If so, incorporating your business may not make sense. You may not be able to benefit from the tax deferral advantage a corporation can offer if you need a significant amount of the corporation's income as salary or dividends to support your living expenses. Keep in mind that using corporate assets to fund personal expenses

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can result in negative tax consequences unless you first withdraw the money from the corporation.

Is your business profitable enough?

If your business is currently generating business losses, you might consider delaying incorporation. As a sole proprietor, it might be beneficial for you to use the business losses against your personal income from other sources.

Is your business expanding? Does it need more money to operate successfully?

If so, incorporating your business may make sense for you, since raising money is often easier for corporations than it is for a sole proprietorship.

Is your business producing more income than it needs to operate?

If so, incorporating your business may make sense for you. You may be able to take advantage of the lower corporate tax rates and the resulting tax deferral advantage by leaving the after-tax business income in the corporation until you need it. In this regard, you may want to ensure the passive investment income earned in your corporation does not grind down your business limit. Alternatively, you may be able to benefit from income splitting opportunities such as paying your adult family members dividends to take advantage of their lower marginal tax rates, provided the TOSI rules don't apply.

Do you need additional money to supplement your retirement?

If so, incorporating your business may make sense for you. By incorporating, you have increased flexibility in choosing the type and amount of remuneration you can receive in retirement. For example, you can choose to leave the funds in your corporation to invest, or have your corporation set up an IPP and/or RCA. This can provide pension benefits and supplemental retirement income, allowing you to maintain your standard of living in retirement.

Do you intend to leave your business to other family members or intend to sell it?

If so, incorporating your business may make sense for you. The corporation continues to exist after your death, and you can pass the shares on to your heirs as you wish. Even if your heirs don't want to continue the business, they may still benefit from the tax deferral by leaving the

money in the corporation to invest. Alternatively, if you plan to sell your business, you might be able to use the LCGE to eliminate the tax on all or a portion of the gain on the sale of shares.

Conclusion

Deciding how to structure your business is an important decision that may have a significant impact on your business going forward. Speak with a qualified tax and legal advisor to ensure incorporation is right for you.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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