

# MANAGING THE SMALL BUSINESS DEDUCTION



## THE ISSUE

The small business deduction (SBD) entitles qualifying small businesses to a favourable corporate income tax rate on the first \$500,000 of active business income in any taxation year.

To qualify, the capital base of the corporation and all associated corporations must not exceed \$15 million, and the SBD benefit will be reduced if the corporation's capital base is between \$10 and \$15 million.

A corporation's capital base includes share capital, retained earnings, and loans including shareholder loans.

How does corporate-owned life insurance impact a corporation's entitlement to the SBD?

*The opinions expressed in this memorandum are strictly those of Westward Advisors Ltd. This memorandum is for information purposes only and is not legal or tax advice.*

## WESTWARD'S VIEW

Many advanced life insurance plans involve a corporation investing retained earnings in the cash value of life insurance. This will not impact the SBD otherwise available because the capital base of the corporation does not change as a result of this transaction.

If a shareholder implements an ICF (a personal investment loan secured by a life insurance policy, the proceeds of which are invested in the corporation by way of shares or a loan), the capital base of the corporation will increase and may reduce the corporation's SBD benefit.

The maximum value of the SBD benefit is approximately \$55,000 annually, depending on the province in which the income is earned. This is just a temporary tax deferral, because the SBD benefit will be lost to personal dividend tax when the corporation pays the after-tax SBD income to shareholders through dividends.

In the worst case scenario, a \$5,000,000 ICF may cause the corporation to forego the full SBD tax deferral benefit. However, a \$5,000,000 ICF produces personal after-tax cash flow that will more than offset the lost SBD benefit.

The following table illustrates the **annual** ICF benefit gained and the maximum SBD benefit lost on a \$5,000,000 ICF.

Province	ICF Benefit Gained	SBD Benefit Lost (max)	ICF Annual Advantage
BC	\$ 96,650	\$ 57,500	\$ 39,150
Alberta	75,500	55,000	20,500
Ontario	108,845	47,500	61,345

When the ICF is below \$5,000,000, the above results can be pro-rated to determine the ICF annual advantage. When the ICF is above \$5,000,000, the ICF benefit continues to increase but the maximum lost SBD benefit is fixed at the amount shown in the table.

Thus, the annual benefit of the ICF is always larger than the lost SBD benefit, and the ICF advantage is even greater when one considers that the SBD benefit is just a deferral of tax, while the ICF benefit is a permanent tax saving.

When considering an ICF, the loss of SBD tax deferral benefits may be a cost to consider, but in most cases, the ICF benefits far outweigh the lost SBD benefits.

