

INCORPORATING YOUR PROFESSIONAL PRACTICE

Most provinces and professional associations in Canada now permit professionals such as doctors, dentists, lawyers, and accountants to carry on their professional practice through corporations. Deciding whether a professional corporation is right for you involves a consideration of several tax and non-tax issues. This Reference Guide provides information in four broad areas:

- ❖ Who may incorporate, and who may own shares of a professional corporation;
- ❖ Deferring tax using the small business deduction;
- ❖ Costs associated with incorporating a professional practice; and
- ❖ Other planning issues and opportunities in incorporating a professional practice.

WHO MAY INCORPORATE, AND WHO MAY OWN SHARES OF A PROFESSIONAL CORPORATION?

Each province, and each profession within each province, may have its own unique set of rules as to who may practice through a professional corporation. In addition, there may be restrictions on such matters as whether or not family members of the professional or a trust may own shares of a professional corporation. These rules and restrictions may restrict the planning options available to you. You should inquire with your Professional Association to determine whether your profession is allowed to incorporate in your jurisdiction.

DEFERRING TAX USING THE SMALL BUSINESS DEDUCTION

Perhaps the primary tax advantage to incorporating a professional practice is the ability to defer a substantial portion of the tax on your professional income. This tax deferral is usually the main reason a professional considers incorporation.

How the Deferral Works

The deferral is achieved by having the corporation retain some of the professional income, where it is taxed at significantly lower rates than if earned personally. Using a corporation to defer tax is similar to using an RRSP to defer tax. Tax on income contributed to an RRSP is deferred until funds are

April 2008

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withdrawn. With a corporation, a portion of the tax on active business income retained in the corporation is deferred until the corporation pays out (or is deemed to pay out) the retained earnings as a dividend or the shareholder disposes of (or is deemed to dispose of) his or her shares.

Currently, the maximum amount of tax that can be deferred each year by incorporating a professional practice can be up to \$120,000 (this maximum will be higher or lower depending on what province you live in). The key to the deferral strategy is the small business deduction which reduces the tax rate on the first \$400,000 of active business income retained in a Canadian controlled private corporation ("CCPC"). The tax deferred is based on the difference between the rate you are currently paying on your professional income, and the rate that the corporation would pay.

For example, the highest marginal tax rate for individuals in 2008 is approximately 46%. A corporation would pay approximately 16% tax on the first \$400,000 of that income in 2008. Therefore, the maximum annual tax deferral is approximately $\$400,000 \times (46\% - 16\%) = \$120,000$.

Please note that these tax rates and the maximum deferral amount are based on an average of all provincial rates. The rates and the deferral amount that would apply to you will be higher or lower, depending on what province you live in. Please see Appendix A of this Guide for your province's rates and maximum deferral amount.

Where retained earnings are not paid out as dividends, or where shares are not disposed of, the longest that tax can be deferred is until the death of the shareholder of the corporation. Tax could potentially be deferred until the death of a surviving spouse of the shareholder if the spouse inherits the professional's shares. At death any individual is deemed to dispose of all his or her capital property (which would include the shares of a professional corporation), unless the property passes to a spouse (or a spousal trust in certain circumstances¹). The deemed disposition at death will trigger all capital gains accruing on the shares.

Dealing with Active Business Income Over \$400,000

Where a professional corporation has business income in excess of \$400,000, it is generally advisable for the corporation to pay such excess out as salaries or bonuses, which are treated as before-tax expenses of the corporation. Although a salary or bonus is taxed as regular income to the shareholder, this avoids an even higher combined rate of tax that would result if such amounts were taxed in

¹ Transferring shares to a spousal trust may not be an option in the case of the shares of a professional corporation that will continue to practice (for example where another professional is a shareholder). In some provinces trusts are not allowed to hold shares in active professional corporations.

the corporation and then paid out as taxable dividends. Salaries and bonuses must be reasonable in relation to the value of the services performed by the recipient.

Note that if a professional corporation's income is less than \$400,000 in a given year, sufficient salary should still be drawn by the professional to maximize RRSP contributions.

Investment Income Earned by a Corporation

Retaining income in a corporation is generally only advantageous for income subject to the small business deduction. Investment income that is taxed in a corporation and then paid out to the shareholder as a dividend will generally attract combined corporate and personal tax at a rate higher than the rate on investment income earned directly by an individual. Therefore we recommend that investment income be paid out each year, rather than be retained in the corporation.

Determining whether you will Benefit from the Deferral

Basically, you should consider incorporating your practice if you are currently earning income that is in excess of the funds necessary to support your lifestyle, you are currently maximizing your personal RRSP contributions, and there is enough time after incorporation before retirement to make the deferral worthwhile. It will be necessary to estimate your annual personal lifestyle expenditures including annual RRSP contributions, estimate your annual income from your professional practice, and determine your desired retirement date.

Incorporating your professional practice will generally only provide a tax deferral benefit where the practice generates enough income so that all of the following apply:

- ❖ *The income generated by the practice is more than enough to meet the after-tax lifestyle expenses of the family.*

If the practice generates only enough (or less than enough) income to meet your lifestyle expenses, there will be pressure to use the corporation's retained earnings. Using corporate property for personal purposes will attract tax personally, making incorporating less advantageous. Using retained earnings to acquire business assets, such as equipment or real estate used in the practice, makes incorporating advantageous. A corporation will have more after tax dollars to acquire business assets.

- ❖ *The income generated by the practice is also more than enough to allow you to make the maximum RRSP contributions to the shareholder and shareholder's spouse's plan.*

Generally, RRSPs provide a greater tax deferral than corporations do. RRSP contributions are fully deductible and therefore are not taxed (as opposed to merely being taxed at a lower rate as with corporations). The investment income earned inside an RRSP is not taxed until withdrawn, whereas investment income earned in a corporation is fully taxed. Therefore, using a corporation to defer tax is only advantageous if you are maximizing RRSP contributions.

- ❖ *The income generated by the practice is also enough to permit the corporation to retain sufficient earnings to make the costs of incorporation worthwhile.*

As discussed below, the costs of incorporating will include initial and ongoing professional fees.

- ❖ *The use of the income retained in the corporation for personal purposes can be deferred for a sufficient period of time to make the strategy worthwhile.*

The shorter the time that tax is deferred or postponed, the lesser the benefit of the deferral. Therefore, if retained earnings will be distributed, or the shares of the corporation are disposed of (or deemed to be disposed of), within a relatively short period of time (less than perhaps five years) incorporating may not be worthwhile.

The Optimal Deferral Scenario

The maximum tax deferral benefit would be enjoyed by someone whose practice generates enough income to permit the individual to retain \$300,000 of professional income in the corporation, and draw a salary sufficient to meet the individual's lifestyle expenses and to make the maximum RRSP contributions.

- ❖ *Example: Consider a practice in Ontario generating \$475,000 of income annually for a practitioner who is single, has no dependants, has lifestyle expenses of \$100,000 annually, and makes the maximum RRSP contribution of \$20,000. The individual's tax liability would be approximately \$193,000.*

Incorporating the practice would significantly reduce the tax burden if the individual drew a \$175,000 salary and retained \$300,000 in the corporation. The individual's personal tax liability on a \$175,000 salary, after making maximum RRSP contribution, would be approximately \$53,000. The corporation's tax liability would be \$51,000. The total personal and corporate tax liability would be approximately \$104,000.

Limits on Access to the Deferral: Associated Corporations and Partnerships

As noted, the deferral of tax with a professional corporation depends on access to the small business deduction. Where two or more corporations are found to be associated or operating in partnership with each other, the ability to access the small business deduction will be affected. However, there may be opportunities to avoid association or partnership. The main issues or concerns regarding associated corporations and partnerships, discussed in more detail below, are as follows.

- ❖ CCPCs that are associated must allocate the \$400,000 small business deduction limit among themselves.
- ❖ There may be opportunities to avoid association of two corporations, for example, if you have a separate management corporation that provides non-professional services.
- ❖ Corporations that are partners must share the \$400,000 small business deduction limit equally.
- ❖ It may be possible to avoid partnership by creating a cost-sharing association. However, a partnership may be found to exist despite your efforts to ensure that there is no partnership.
- ❖ If you do wish to work in partnership with another professional, you should carefully consider your corporate structure in light of estate planning issues as well as business or tax planning issues.

Associated Canadian Controlled Private Corporations

Where two or more CCPCs are “associated” they must agree to allocate the \$400,000 small business deduction limit between them. If they fail to do so, they risk losing the deduction or having the Minister of National Revenue make the allocation for them. Generally speaking, two corporations are “associated” if they are directly or indirectly controlled by the same person or related group of persons.

If you have an interest in any other private corporation, you should obtain legal and accounting advice about how this might affect your professional corporation’s ability to access the small business deduction, and what agreements, if any, should be filed with the corporations’ tax returns allocating the small business deduction.

Avoiding Association of Two Corporations

In some cases association of two corporations can be avoided. For example, some professionals have management corporations that provide non-professional services to the professional for a fee. If you have such an arrangement and you are considering incorporating your practice, you should consider whether association can be avoided through careful structuring of the ownership of shares, and control of the corporations, by you and your spouse or other family members. The tax rules regarding association are complex, so a careful analysis by your professional tax advisors would be required. If association is avoided, the corporations would not have to share the small business deduction limit, and each could have the first \$400,000 of its income taxed at the low small business rate. Of course, this strategy is only useful where there is enough revenue from the practice to retain more than \$400,000 in the corporations.

Corporations that are Partners

Where there is a partnership of professional corporations, the small business deduction limit must be shared equally among the partners, with no possible allocation of the \$400,000 limit as with associated corporations. Therefore, arranging professional corporations in partnership will generally only be useful where the number of partners is small. If there are more than perhaps five partner corporations, the amount of small business deduction limit available to each becomes much less significant.

Non-Partnership Arrangements

Some business owners or professionals consider alternative arrangements to allow them to have a business relationship while ensuring there is no partnership for small business deduction purposes. For example, arrangements among corporations such as cost sharing associations or joint ventures are sometimes considered. A cost sharing association would more typically be considered by professionals. Two professional corporations that share costs but are not partners can each enjoy access to their own small business deduction limit. If you are considering such an arrangement, you and your professional advisors will need to carefully examine the arrangement to ensure it is not in fact a partnership. Legally a partnership may exist despite the presence or absence of any formal arrangement or agreement. Even where the parties have an agreement indicating they are something other than partners, a partnership may be found to exist based on all the facts and circumstances.

Working in Partnership with Another Professional

If you nevertheless wish to work in partnership with another professional, it would generally be better to have your corporation enter into the partnership with the other professional (or corporation controlled by the other professional), than to

make the other professional a shareholder of your corporation. There is a considerable increase in the complexity of estate planning where two professionals are shareholders of one corporation. Under the legislation or rules applicable to your profession in your province, the estate of a deceased professional shareholder may be required to dispose of its interest in the corporation to avoid causing the loss of the corporation's permit to practice professionally. This may require the surviving partner or the estate and the deceased's family members to divest themselves of their interests in the corporation within a relatively short time frame.

COSTS ASSOCIATED WITH INCORPORATING

Legal and Accounting Costs

The costs of incorporating and maintaining a corporation are modest in relation to the potential tax benefits. However, you will need to obtain an estimate of the initial and ongoing cost of incorporation from your legal and accounting professionals. A corporation requires more attention and entails more complexity (since personal and corporate property and expenses must be kept strictly separate). Unless a meaningful amount of tax is deferred or eliminated, the added expense and complexity of a corporation is not worthwhile to most individuals.

Costs of Dissolving a Partnership

If you decide to dissolve your existing partnership to allow incorporation, you will need to consider any additional costs associated with dissolving the partnership. Such costs could include professional fees and taxes on capital gains realized on the disposition of your partnership interest. There could also be practical problems to deal with, such as the loss of your existing profit sharing relationship.

OTHER PLANNING ISSUES AND OPPORTUNITIES

Income Tax Reduction

Sometimes taxes can be reduced and not merely deferred. If you receive a dividend from your corporation at a time when you are taxed in the low or middle tax brackets rather than the highest brackets, you will pay less personal tax. Income from a professional practice may fluctuate significantly from year to year, or you may at some point anticipate having lower income (and a lower tax bracket) in a future year. Income could be accumulated in the corporation during high-income years and paid out as dividends in lower income years. Thus, a professional corporation may allow your year-to-year income to be smoothed or leveled for optimal utilization of your marginal tax brackets.

Deferring Tax on Salaries or Bonuses

Payment of salary or bonus from a corporation may give rise to another tax deferral opportunity. Under income tax laws, your corporation may deduct as an expense from its income any salary or bonus declared payable to you in the taxation year. Even if the bonus is not actually paid to you by the corporation's year-end, the amount may still be deducted for that year as long as it is actually paid to you within 180 days of the year-end. The result is a tax deferral: your corporation deducts the amount in one year, but you don't have to include the amount in your income until the next year.

Income Splitting

The use of a professional corporation may create new opportunities to split income with members of your family. Where any lower-income family members (or a trust for their benefit) are shareholders of a professional corporation, it may be possible to pay dividends to them, to be taxed at their low marginal rates. Particularly where your family members have little or no other income, great tax efficiency can be achieved through payment of such dividends.

However, note that in some provinces, the legislation governing certain professions prohibits the ownership of shares by the professional's family members. If such a prohibition applies to you, income splitting through payment of dividends will not be possible for you. Some of the applicable legislation or rules permit family members to own shares, but do not allow a family trust to own shares, reducing the flexibility of income splitting or wealth transfer strategies.

There are many complex issues that must be considered if a dividend income splitting strategy is to be effective. A few of these issues, discussed in more detail below, are as follows.

- ❖ The "income splitting tax" has largely eliminated the opportunity to split income with minor children through the payment of dividends.
- ❖ Where a trust is not allowed for your profession, your corporate share structure may need to be more complex to allow flexibility in paying dividends to family members.
- ❖ Where family members or a family trust own shares, maintaining "small business corporation" ("SBC") status may be important, to ensure that "corporate attribution" does not apply.

The Income Splitting Tax

The "income splitting tax" (the "kiddie tax") has largely eliminated the opportunity to split income with minor children through the payment of dividends. Generally, if any minor child receives a dividend from your professional corporation (either

directly or through a trust), the kiddie tax will apply, and the dividend will be taxed at the highest marginal rate. Therefore, this kind of dividend income splitting will only be possible with low-income adult children or a spouse. Note that it would be possible in the absence of a corporation to pay your spouse or other family members a reasonable salary for services provided in any event. Therefore paying such salaries should be considered as a potential alternative income splitting strategy.

Complexity of Share Structure Where Trust not Permitted

If the provincial legislation relevant to you allows you to issue shares to family members but not to a family trust, it may be necessary to create several distinct classes of shares which are entitled to discretionary dividend payments. For example, you might want each family member to own a separate class of shares, so you can pay a dividend to one family member without also having to pay it to others. To allow the corporation this flexibility to distribute income in a manner you see as appropriate, without offending certain complex attribution rules, special care would have to be taken when structuring the rights and attributes of the various classes of shares. Although recent court decisions have confirmed the efficacy of such arrangements, there is still some risk that they may be challenged by the CRA under anti-avoidance provisions of the Income Tax Act.

Maintaining SBC Status to Avoid Corporate Attribution

Where shares are issued to a spouse or minor child, or to a trust for their benefit, it will be important to ensure that the corporation qualifies as a “small business corporation” (“SBC”) to avoid attribution rules. A corporation is an SBC where all or substantially all (generally 90%) of the fair market value of all the assets of the corporation are used in an active business primarily carried on in Canada. At any time while the corporation does not meet this 90% asset test, “corporate attribution” will apply. Corporate attribution may deem you to receive a certain amount of interest income each year, whether or not you actually reduced your tax burden through the arrangement.

Note that full enjoyment of the small business deduction deferral (by retaining income in your professional corporation) may prevent the corporation from meeting the 90% asset test by allowing a buildup of passive investment assets in the corporation. In some cases it may be possible to use a holding corporation to withdraw passive investments from the professional corporation by receiving tax-deferred dividends from the professional corporation (subject to any applicable rules prohibiting a holding corporation from owning shares of the professional corporation). The structure and ownership of the holding corporation would itself need to be carefully considered to ensure that attribution rules and other anti-avoidance rules do not apply.

Enhanced Capital Gains Exemption

One potential benefit of incorporating is access to the \$750,000 capital gains exemption (“CGE”). The CGE permits individuals to shelter up to \$750,000 in capital gains from tax upon the sale or deemed sale of qualifying small business corporation shares (“QSBC Shares”), except to the extent that any amount of capital gains exemption was previously claimed.

The availability of the CGE should not be a significant factor in deciding whether to incorporate. Firstly, the CGE may not be useful to you. The CGE would only be of use if you were ever to sell your shares in the professional corporation, rather than assets. It is more likely that you will sell the goodwill and assets used in your practice rather than the shares of a corporation, since purchasers generally prefer to purchase assets over shares.

There are a number of stringent tests that your professional corporation would have to satisfy before its shares could be QSBC Shares. One of the tests requires that at the determination time (e.g. the time you dispose of the shares) the shares must be shares of a SBC, meeting the 90% asset test described above. Also, for a period of 24 months before that time, the shares must meet a similar test, with a 50% active asset threshold applying.

Note that full enjoyment of the small business deduction deferral may prevent the shares in your professional practice from qualifying as QSBC Shares. In some cases it may be possible to use a holding corporation to withdraw passive investments from the professional corporation through the payment of tax-deferred inter-corporate dividends (subject to any applicable rules prohibiting a holding corporation from owning shares of the professional corporation).

Other Tax Strategies

It may be more cost efficient to pay non-deductible expenses related to your practice (for example, club membership dues) out of the corporation’s income, which is taxed at the low small business rate, rather than out of your personal income. However, note that if such an expense is considered to be a taxable employee benefit, the amount of the expense will have to be included in your personal income.

If you need to buy a building as part of your practice, it could be cost efficient to have the corporation buy the building and make mortgage payments out of its low-rate income.

Other tax strategies may become available due to the fact that the use of a corporation will create an employer/employee relationship. A few of these strategies are the use of individual pension plans, retirement compensation

arrangements as well as private health service plans. These could be explored with your professional advisors.

Limited Creditor Protection

Creditor protection is normally not one of the more significant factors in deciding whether a professional should incorporate.

Generally the shareholders of a corporation are not liable for claims against the corporation. However, in the case of a professional corporation the professional is still personally liable for claims arising from the provision of professional services (for example, negligence claims by patients or clients). Shareholders are jointly and severally liable with a professional corporation for professional liability.

However, the professional will generally have limited liability concerning claims against the corporation by ordinary business creditors such as, for example, landlords and suppliers (subject to any personal guarantees the professional may have given).

CONCLUSION

A professional corporation may provide significant tax benefits for you if your professional practice generates enough income to make the tax deferral worthwhile. Many other facts and circumstances will need to be considered by you and your professional financial, tax and legal advisors to determine whether a professional corporation is right for you. Your advisors will also be able to determine whether any other benefits of incorporation, such as those discussed above, will be available to you.

Appendix A
MAXIMUM DEFERRAL BY PROVINCE IN 2008

Province	Highest Rate for an Individual's Income	Rate on Active Business Income up to \$400,000	Maximum Deferral Using Professional Corporation
British Columbia	43.7%	15.5%	\$112,800
Alberta	39.0%	14.0%	\$100,000
Saskatchewan	44.0%	15.5%	\$114,000
Manitoba	46.4%	13.0%	\$133,600
Ontario	46.4%	16.5%	\$119,600
Quebec	48.2%	19.0%	\$116,800
New Brunswick	47.0%	16.0%	\$124,000
Nova Scotia	48.3%	16.0%	\$129,200
Prince Edward Island	47.4%	14.2%	\$132,800
Newfoundland and Labrador	45.5%	16.0%	\$118,000
Northwest Territories	43.1%	15.0%	\$112,400
Nunavut	40.5%	15.0%	\$102,000
Yukon	42.4%	15.0%	\$109,600