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Investment Insight

Professional corporations offer tax breaks

Many professionals in Canada are able to incorporate their practice, which allows them the opportunity to earn income through a corporation. Who's included in the definition of a professional? This will depend upon the provincial and territorial legislation, but generally includes regulated professionals, such as architects, chiropractors, pharmacists, engineers, physicians, dentists, lawyers, accountants, and veterinarians.

So, you might be wondering, who's a good candidate for incorporation, and what are the benefits? In this article, we discuss the pros and cons of professionals incorporating, and offer some guidance for using these corporations (also known as "professional corporations") to their utmost advantage.

The tax advantages to incorporating

The main reason for any professional to consider incorporating is often the significant tax advantages. If the professional leaves profits in the corporation to be taxed (versus taking out all the profits as a salary or dividend) the corporation's tax rate on those profits likely will be much less than the professional's personal tax rate. In addition, there can be significant tax savings on the sale of the corporation (including the deemed sale on death) due to the ability to claim up to the lifetime capitals gains exemption on the sale of shares. Here are some details:

Small Business Deduction

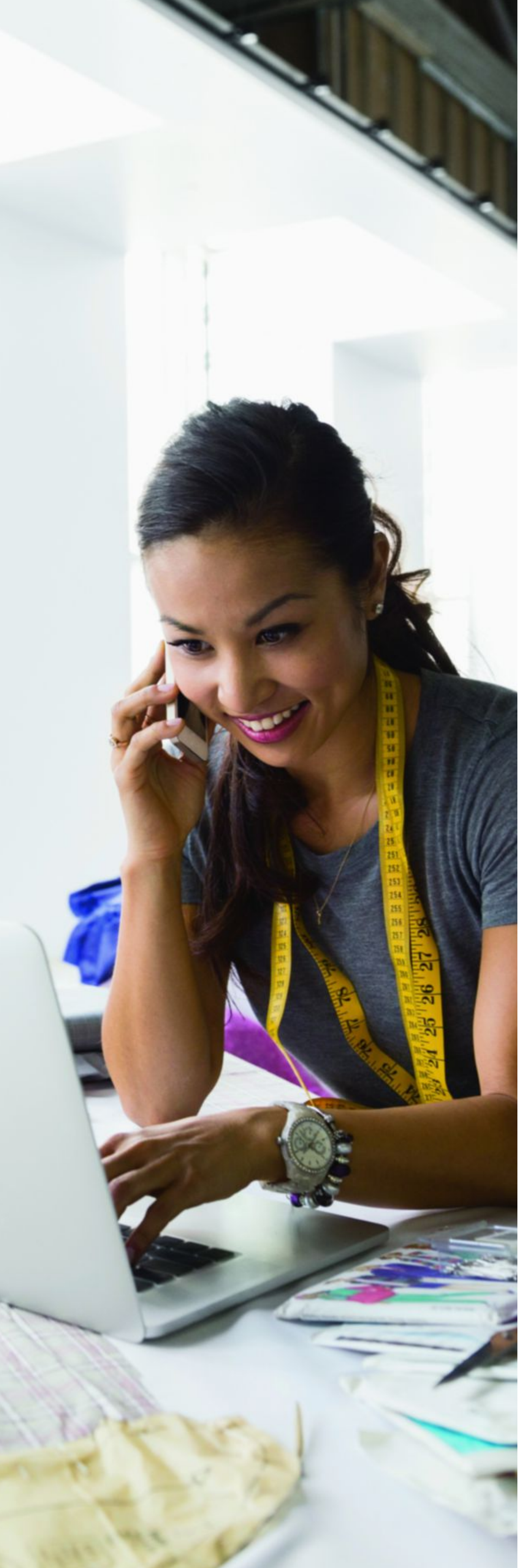
In most provinces and territories, the first $500,000[1] of active business income earned by a corporation is subject to a very low rate of tax, approximately 13 per cent depending on the province or territory. This low tax rate is due in part to a special tax deduction called the small business deduction ("SBD"). This means that by incorporating, those professionals with the ability to leave some profits in the corporation will see quite a large deferral of tax – at least 35 per cent (depending upon their province or territory of residence) of active business income versus the situation where profits are earned in an unincorporated practice and taxed at the owner's high marginal (personal) tax rate. Of course, once salaries or dividends are paid out to the professional, he or she has to pay personal tax on the income withdrawn, and the tax deferral comes to an end.

Consider the example of Joanne, who's a professional operating through a corporation. Her corporation generates $700,000 of income. Joanne is going to pay herself $200,000 in salary this year out of the company. This keeps her corporate income at $500,000, the SBD threshold for her province, and means it will benefit from being taxed at the preferred small business tax rate of 13 per cent.

If Joanne was to receive additional income in her hands personally, she would pay tax at 48 per cent (the highest personal marginal tax rate in her province). The remaining $500,000 ($700,000 – $200,000) of income left in the corporation will be taxed at 13 per cent (the tax rate on the first $500,000 of active business income in Joanne's province). Joanne's tax deferral in this case on that $500,000 is 35 per cent (48 per cent minus 13 per cent).[2] Once Joanne pays the remaining $425,000 ($500,000 – $75,000 of tax) out of the corporation to herself as salary or dividends she'll pay some tax personally on the income received, and the deferral of tax ends.

[1] Small business threshold is $600,000 for Saskatchewan. In all other provinces and territories the small business threshold is $500,000 which is equivalent to the federal amount.

[2] This example assumes a small business deduction threshold of $500,000, small business tax rate of 13 per cent on active business income and a top marginal tax rate for individuals of 48 per cent. These rates will vary by province or territory.



Lifetime Capital Gains Exemption

Upon the sale of shares of a qualifying corporation (or on death), the owner can offset the first $866,912 (2019) of capital gains with the lifetime capital gains exemption (if certain tests are met).

No such deduction is available on the sale of an unincorporated business. If the professional corporation owns a practice with a tangible value and the owner can sell the shares of this corporation in the future, this is a planning opportunity that shouldn't be missed.

Income splitting using professional corporations

In a regular corporation (that's family-owned and operated), it's common practice to have other family members as shareholders. Where family members such as a spouse or adult children make meaningful contributions of either capital or labour or both, this provides income splitting benefits since dividends can be paid to the family members and taxed in their hands. When labour and/or capital contributions fall short of the requirements of the Income Tax Act of Canada (ITA), tax on split income (TOSI) may apply. This would result in such dividends being taxed at top tax rates. This is one advantage that may be lost in a professional corporation.

Many (but not all) provinces/territories and/or professional regulatory bodies restrict share ownership in the corporation to members of the particular profession. For example, in many provinces or territories, the governing legislation states "all the issued and outstanding shares of the corporation shall be legally and beneficially owned, directly or indirectly, by one or more members of the same profession."

However, certain provinces/territories (i.e. Ontario and British Columbia) offer more relaxed share ownership roles by family members of specific professionals. For example, in Ontario physicians and dentists are permitted to have family members (i.e. spouse, adult children, or a trust for minor children) own non-voting shares in the professional corporation. In these situations you may be able to split income through a corporation by paying dividends to adult family members who are shareholders.

Even though it may not be possible to income split by sprinkling share ownership amongst family members, there are other income splitting techniques available. An easy strategy is to hire family members to work in the business. So long as a reasonable wage is being paid for the services being rendered, the wages are deductible from the corporation's income, and are taxed in the hands of the family members receiving the wages.

Disadvantages of a professional corporation

As expected, with the good can also come some bad. Some disadvantages that may affect the decision to incorporate include:

- All corporate partners must share the $500,000 SBD. If the professional is currently in a partnership with others, the tax advantages of the SBD may be lost, particularly if the partnership on a whole earns net income significantly greater than this $500,000 threshold
- Costs of the professional corporation also should be considered. Professional fees will be necessary to establish and maintain the corporation. In addition, there will be increased income tax compliance costs annually, such as the filing of a corporate tax return, T4 slips for salaries, and T5 slips for dividends

Other considerations

Some other matters to take into account when deciding whether or not to incorporate a professional practice include:

Flexibility: Corporations offer the professional more flexibility than the traditional unincorporated practice. For example, any taxation year-end may be chosen for a corporation, while income must be reported on a calendar year basis in an unincorporated business.

In addition, the professional has the choice between taking salary and dividends as compensation with a corporation. In an unincorporated business, the profits are simply taxed as business income on the business owner's personal tax return.

Liability: One traditional benefit of incorporating that cannot be enjoyed by the owner(s) of a professional corporation is the protection from personal liability in the case of professional negligence. Professionals should check with their provincial or territorial regulatory body for details under these circumstances, but the general rule is, if there's professional malpractice, the shareholder (professional) would be personally liable. However, there can be limited personal liability from other types of creditor attacks on the corporation (i.e. non-professional liabilities such as trade payables, office space lease liabilities and bank loans that haven't been personally guaranteed).

Investing inside the corporation

The tax benefits to a professional corporation are best enjoyed when profits can be left in the corporation after being taxed at lower corporate rates. Of course, this leads to the question of what to do with these profits.

Most commonly, the residual cash will be invested inside that corporation. It's important to consider the tax rates that apply to any investment income inside the corporation since the small business deduction won't apply to this investment income. Interest income will be taxed at the highest corporate tax rate (exceeding 50 per cent, but this varies by province/territory), capital gains at one-half that rate, and portfolio dividends received from taxable Canadian corporations (also called "portfolio dividends") at a flat rate of 38 1/3 per cent. Because of the differences in the tax rates, it's important to invest the profits tax efficiently inside the corporation so that unnecessary taxes are not incurred each year. For further information about corporations owning investments refer to the article entitled "Investments Owned by Private Corporations", MK2206.

Other issues to consider when investing inside a professional corporation

- The Lifetime Capital Gains Exemption. If the owner's goal is to claim the lifetime capital gains exemption at some point in the future, it will be important to keep a careful eye on the amount of investments inside the corporation. If too large an amount of investments is kept inside the corporation, it's possible that the corporation will be tainted for purposes of this exemption. This reaffirms that it's important to work with a tax professional to ensure that the corporation continues to qualify for the exemption

- The provincial/territorial laws and specific regulations and by-laws of each professional governing body must be reviewed to understand the investment activities that are allowed or to see if it's even possible to invest inside the corporation. This has been of special interest in Ontario where the provincial rules state that the investment activities cannot be at such a level to constitute a separate business. However, this doesn't mean that no investments can be made in the corporation – the rules go on to say that the temporary investment of surplus funds is all right. While a reasonable interpretation might be that passive investments, such as Guaranteed Investment Certificates (GICs), stocks, mutual funds or segregated fund contracts, of surplus funds should be fine, this is an area that requires further clarification. Each situation will be different and it is important to work with a professional familiar with the guidelines for the particular profession.
- If the professional wishes to keep the investments outside of the professional corporation, there are ways this can be done on a tax efficient basis

Where allowed, a holding company can be set up and dividends can be paid on a tax-free basis from the professional corporation to the holding company. In provinces/territories where a holding company wouldn't be allowed to hold the shares of the professional corporation (because only members of the profession can be a shareholder), a separate management company can be established, and fees can be charged between the companies in order to get profits into that management company. The remaining profits in the management company can be used for investment purposes. Keep in mind however that the Goods and Services Tax/Harmonized Sales Tax (GST/HST) charged by the management company to the professional corporation may not be recoverable by the professional if they cannot claim an input tax credit.

Summary

At the end of the day, incorporation may or may not be a feasible option for all professionals. If a professional relies upon all of his/her profits to fund day-to-day living expenses, now may not be the time to incorporate since the costs of taking salary or dividends – as well as setting up and maintaining the corporation – may very well exceed any of the tax benefits.

However, once a professional is in the position that some profits can be left in the corporation to be taxed, incorporation can provide a significant tax deferral. If you think that incorporation would benefit you, be sure to speak to your advisor who can help you consider the pros and cons of your particular situation.

Investment options available through manulife

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