Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Professional corporations

Is incorporating your professional practice right for you?

As a sole proprietor, you may be wondering whether to incorporate your practice or not. While incorporating is good for some, not all practices will necessarily benefit from a corporate structure. If you're considering incorporating your practice, you should take time to learn about the possible advantages and drawbacks of incorporation. This article highlights some of the points you may want to review when determining whether to incorporate your practice.

The terms "corporation" and "company" are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation not controlled by a non-resident of Canada or a public corporation, or a combination of both. In addition, no class of shares of a CCPC can be listed on a designated stock exchange.

What is incorporation?

The act of incorporating creates a new legal entity. 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.

What is a professional corporation?

A professional corporation is a corporation owned and operated by one or more members of the same profession. Only members of certain professions, such as physicians, lawyers, accountants and dentists, can operate a professional corporation. The services provided by the corporation are generally restricted to the practice of the profession.

Professional corporations are allowed in every province and territory across Canada. In each jurisdiction, the professional regulatory body usually determines whether its members may incorporate. For example, the regulatory body for physicians, in all provinces and territories, allows physicians to incorporate.

How does a professional corporation differ from a regular corporation?

The following are some significant differences between a professional corporation and a regular corporation:

- In many, but not all, provinces and territories, only members of the same profession can be voting shareholders of a professional corporation. Each profession in each province or territory has specific rules as to who can hold the shares of a professional corporation. For example, these rules could state whether the shares can be held by a holding company, family members or a family trust. There are no such restrictions on who can be the shareholder of a regular corporation.
- The officers and directors of a professional corporation must generally be shareholders of the corporation as well. There are no such restrictions on the officers and directions of a regular corporation.
- The professional corporation is generally subject to the investigative and regulatory powers of the regulatory body governing the profession. Depending on the type of business being operated by a regular corporation, the corporation may not be subject to regulatory oversight.
- A professional corporation will not protect a professional against personal liability for professional negligence. Generally, a shareholder of a regular corporation is not liable for the corporation's debts unless they've provided a personal guarantee.

Because of these differences, some of the benefits commonly associated with a corporation may have a limited application for a professional corporation. Some of the advantages of incorporating and the restrictions placed on professional corporations are further explained in the following sections.

Advantages of incorporation

There are several potential advantages to incorporating your professional practice. The following is a non-exhaustive list of these advantages.

Tax deferral

Perhaps the most significant advantage of operating your practice within a corporation is the ability to defer taxes. Professional income earned within a corporation is taxed at two levels — once at the corporate level and then again at the personal level when the income is distributed. By incorporating and earning professional income within your corporation, you can defer personal taxation on the professional income until the time you withdraw it from your corporation. Generally, the longer you can leave the funds in your corporation, the greater the deferral advantage will be.

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This tax deferral is available because income earned from operating your practice within a corporation may be taxed at lower corporate tax rates than professional income earned while operating as a sole proprietor, where the income is taxed at your individual marginal tax rate. If the professional income is earned by your corporation, the taxable income may be considered active business income (ABI) for tax purposes and be subject to a general federal corporate tax rate of 15% plus the applicable provincial or territorial corporate tax rate. Further, if your corporation is a CCPC throughout the tax year, your corporation may benefit from the small business deduction (SBD), which lowers the federal tax rate to 9% on its first $500,000 of ABI (known as the "business limit").

As a result of these lower corporate tax rates for ABI, if you incorporated your practice, you may have more after-tax professional income to invest inside your corporation. Due to the larger amount of starting capital, you may realize after-tax returns that exceed what you may have realized in a personal investment account.

In an attempt to limit this tax deferral benefit for corporations, the federal government introduced rules to restrict access to the SBD for CCPCs that have significant income from passive investments. A CCPC will have its federal small business limit reduced on a straight-line basis where the CCPC and its associated corporations earn between $50,000 and $150,000 of passive investment income in a year. The business limit will be reduced by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit will be eliminated if a CCPC, and its associated corporations, earn at least $150,000 of passive investment income in a year. The provincial or territorial small business limit may also be reduced for CCPCs that have significant income from passive investments, so it's important to confirm the specific rules for your province or territory of residence with a qualified tax

advisor. The term "associated corporations" is defined in the Income Tax Act. The definition is complex and is beyond the scope of this article.

All provinces and territories also provide an SBD. Additional criteria must be met in order to qualify for the Quebec SBD. Corporations will only qualify for the Quebec SBD if they operate in the primary or manufacturing sectors or where the corporation meets the minimum number of remunerated hours test.

In addition to the reduction based on passive investments, the federal business limit may be reduced 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. The actual reduction of a corporation's business limit is the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income. Finally, the business limit must be allocated among all associated corporations.

Income splitting opportunities

Incorporating your practice may allow you to take advantage of income splitting opportunities. By having your lower-income adult family members as shareholders, it is possible for your incorporated business to pay them dividends to take advantage of their lower marginal tax rates. This strategy may be less applicable to professional corporations situated in provinces or territories where share ownership is restricted to members of a particular profession. In addition, it's important to note that there are "tax on split income" (TOSI) rules which limit splitting certain types of income with family members.

These TOSI rules apply to many types of income received from a private corporation, including interest, dividends, shareholder benefits as well as certain capital gains, but they do not apply to salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income loses the ability to claim personal tax credits on the split income, except for the disability tax credit, dividend tax credit or foreign tax credit.

There are some exclusions to TOSI, however the exclusions are more restrictive for professional corporations. The exclusions mainly 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 a certain portion of the votes and value of the corporation's shares. There's also an exclusion available to the spouse of a professional 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.

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The process of making family members shareholders of your corporation is complex and may result in immediate tax consequences. Speak a qualified tax and legal advisor for more information regarding a reorganization of your corporation.

You can also split income with family members using other methods that don't require you to incorporate your practice 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 the reasonable salaries paid.

The lifetime capital gains exemption (LCGE)

You may enjoy a significant tax break on the capital gains 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 practice may enable you to sell your practice and shelter the growth from tax, up to the LCGE limit. Please note that the ability to sell the shares of your professional practice might be more limited due to the requirement that voting shares generally have to be owned by individuals of the same profession.

You and your family may also be able to multiply the LCGE available on the disposition of QSBC shares if you and your family members own shares of your professional corporation, directly or indirectly. Please note that if you multiply the LCGE with your family members, they become entitled to some of the proceeds of sale. It's

important this is your intention when contemplating such planning. Again, the benefits of this strategy may be limited for professional corporations situated in provinces or territories where share ownership is restricted to members of a particular profession.

For more information regarding the types of shares that qualify as 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 practice, 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 professional corporation.

Flexibility in remuneration

By incorporating your practice, you gain access to use a combination of different forms of remuneration, including salary, dividends and bonuses. 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.

Flexibility in employee benefits

By incorporating your practice, you gain access to certain types of employee benefits or retirement savings plans, such 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 or key employees. An IPP may be ideally suited for individuals over age 40 who earn a substantial amount of employment income. It's usually established for one individual member, say, yourself as the practice owner, but the benefits can be extended to your spouse and other family members if they're also 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 benefits with your spouse, which may further lower your family's overall tax bill.

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Lastly, in the event you or your practice run into financial trouble, the assets in the IPP are generally protected from creditors. This may allow you to set aside significant amounts 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.

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 may also include a registered pension plan (RPP) such as an IPP set up by the company. An RCA may also provide pension benefits where 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 you or your company can contribute to the plan, provided the amounts are "reasonable". Keep in mind, the contributions to the 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 funds are left in the corporation to invest or in an IPP.

You will not be taxed 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 RCA income with your spouse in retirement, subject to a limit.

Lastly, 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.

That said, a professional corporation doesn't generally protect you from personal liability for professional negligence. In addition, if a shareholder is also a director, that person could be liable for certain professional

corporate liabilities (which may include unpaid wages and payroll taxes) in their capacity as a director.

Period of existence

If you operated your practice as a sole proprietorship or a partnership, your business would cease to exist upon your death. On the other hand, if you incorporated, your corporation would continue to exist even if every shareholder and director were to pass away. However, it's important to keep in mind that there may be restrictions on who can own the voting shares of a professional corporation. Generally, voting shares have to be owned by individuals of the same profession, and the corporation may not carry on a business other than the practice of the profession. When the professional dies or no longer practices (assuming there are no other professionals who are shareholders), the corporation would lose its status as a professional corporation unless another individual of the same profession purchases the shares. This doesn't mean the corporation would have to be wound up. It may continue to exist as a regular corporation.

Disadvantages of incorporation

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

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 practice 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 practice, 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, your incorporated business 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.

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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 practice can generate losses due to high start-up costs and/or building a client base. As a sole proprietor, you may use any professional losses to offset your personal income from other sources. However, once you've incorporated, any losses realized in the corporation must be applied against the corporation's income and can't be used to offset your personal income.

Whether you incur these losses as a sole proprietor or through your corporation, if you can't use the losses in the year they are incurred, they're not completely lost. Professional losses can generally be carried back three years and forward for 20 years to use against past or future income.

Restricted personal use of corporate funds

All of the professional income you earn as a sole proprietor is taxed in your hands annually. 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 professional corporation, and you can't use the corporate funds for personal expenses unless you first withdraw the money from the corporation. Depending on how you withdraw funds from the corporation (e.g. as salary, bonus or dividend), you'll face different tax implications on the withdrawal.

Taxes at death

If you own shares of your corporation, you may be subject to double taxation. 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 in the future, a second level of tax is triggered. Alternatively, a redemption of the shares by your estate or your beneficiaries may result in a taxable dividend.

It is possible to defer this potential double tax by transferring the shares of your company 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 of double taxation. For more information on strategies that may mitigate this double tax exposure, talk to your qualified tax advisor.

Should you incorporate?

After familiarizing yourself with some of the advantages and disadvantages of incorporating, here are some questions you can consider when determining whether you should incorporate your professional practice:

Do you need a substantial portion of your professional income to fund your annual living expenses and meet your financial goals?
If so, incorporating your practice may not make sense. You may not be able to benefit from the tax deferral advantage a corporation can offer if you need to receive 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 can result in negative tax consequences unless you first withdraw the money from the corporation.

Is your practice profitable enough?
If your practice is in the early stages and currently generating losses, you might consider delaying incorporation. As a sole proprietor, it might be beneficial for you to use the professional losses against your personal income from other sources.

Is your practice producing more income than it needs to operate?
If so, incorporating your practice 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 professional corporation until you need it. In this regard, you may want to ensure the passive investment income earned in your corporation doesn't grind down your small 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. Speak with your qualified tax advisor to see if you can benefit from income splitting in your province or territory of residence.

Do you need additional money to supplement your retirement?
If so, incorporating your practice may make sense for you. By incorporating, you have increased flexibility in choosing the type and amount of remuneration you receive in retirement. For example, you can choose to leave the funds in your corporation for investing or have your corporation set up an IPP or RCA which can provide you with supplemental pension benefits, allowing you to maintain your standard of living in retirement.

Do you need to consider the succession of your practice?
If so, incorporating your practice may make sense for you. If you have a professional in your family who wishes to take over your practice, your professional corporation will continue to exist after your death and you can transfer it to that family member. If there's no professional in your family, your heirs may still benefit from tax deferral by leaving the money in the corporation to invest. Alternatively, if you plan on selling your practice, you might be able to use the LCGE to eliminate the tax on all or a portion of the gain on the sale.

Conclusion

Determining how to structure your practice is an important decision that may have a significant impact on your practice going forward. Speak with a qualified tax and legal advisor to ensure you've taken into account all of your circumstances before deciding whether or not to incorporate.

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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