Reference Guide

INCORPORATING YOUR PROFESSIONAL PRACTICE

WEALTH PLANNING GROUP

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PRIVATE CLIENT

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 the following 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, another corporation 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 Tax on income contributed to an RRSP is deferred until funds are withdrawn.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 $212,500 (the amount of tax deferred depends on the province in which you live). The key to the deferral strategy is the small business deduction (SBD) which reduces the tax rate on the first $500,000 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, assuming the highest marginal tax rate for individuals is approximately 50% and the corporation pays approximately 12% tax on the first $500,000 of active business income, there would be a tax deferral of 38%. Therefore, the maximum annual tax deferral is approximately $190,000 ($500,000 x 38%) in this example.

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, an individual is deemed to dispose of all his or her capital property (which would include the shares of a professional corporation), unless the property is transferred to a spouse (or a spousal trust in certain circumstances[1]). The deemed disposition at death will trigger all capital gains accruing on the shares.

Dealing with Active Business Income in excess of the SBD Limit

Where a professional corporation has business income in excess of its SBD limit, it is subject to a higher general rate of tax than the SBD rate but still lower than the highest marginal personal tax rate. For example, a corporation may incur approximately 28% tax on active business income beyond its SBD limit.

Accordingly, options for dealing with income in excess of the SBD include the following:

- pay such excess as salaries or bonuses, which are treated as expenses of the corporation. Salaries and bonuses must be reasonable in relation to the value of the services performed by the recipient.

- retain and tax the excess income within the corporation to take advantage of a smaller corporate tax deferral, 22% in the example above being the highest personal tax rate of 50% less the general corporate tax rate of 28%. This could allow the corporation to later pay eligible dividends[2] to the shareholders .

The decision on what to do with active business income beyond the SBD limit should be determined on an annual basis with consultation with your professional advisors, considering your overall current and future circumstances and needs.

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[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 also not allowed to hold shares in active professional corporations.

[2] Eligible dividends are subject to a lower personal tax rate than ordinary non-eligible dividends.

Determining whether you will benefit from the deferral

Basically, you should consider incorporating your professional 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 your 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. However, 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 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 (perhaps less than five years) the deferral benefit of 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 $500,000 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 $750,000 of active business income annually for a practitioner who is single, has no dependants, has lifestyle expenses of $140,000 annually, and makes the maximum RRSP contribution of $27,000. The individual's tax liability would be approximately $347,000.

- Incorporating the practice would significantly reduce the tax burden if the individual drew a $250,000 salary and retained $500,000 in the corporation. The individual's personal tax liability on a $250,000 salary, after making maximum RRSP contribution, would be approximately $81,000. The corporation's tax liability would be approximately $61,000, assuming the SBD rate applies. The total personal and corporate tax liability would be approximately $142,000 resulting in an annual tax deferral of $205,000.

Potential deferral if $200,000 of income were retained in the corporation

Incorporation need not be limited to instances when only $500,000 of income can be retained in the corporation. Leaving a moderate amount of income in the corporation can still generate sizeable tax deferrals.

- Example: Consider a practice in Ontario generating $450,000 of income annually for a practitioner who is single, has no dependents, has lifestyle expenses of $140,000 annually, and makes the maximum RRSP contribution of $27,000. The individual's tax liability would be approximately $187,000.

- Incorporating the practice would still reduce the tax burden if the individual drew a $250,000 salary and retained $200,000 in the corporation. The individual's personal tax liability on a $250,000 salary, after making maximum RRSP contribution, would be approximately $81,000. The corporation's tax liability would be approximately $24,000, assuming the SBD rate applies. The total personal and corporate tax liability would be approximately $105,000 resulting in an annual tax deferral of $82,000.

LIMITS ON ACCESS TO THE SBD DEFERRAL

Associated corporations

Where two or more corporations are found to be associated or operating in partnership with each other, the ability to access the SBD 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 $500,000 SBD limit among themselves.

- Corporations that are partners must share the $500,000 SBD limit proportionally.
- 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.

Excessive adjusted aggregate investment income

New rules govern the taxation of passive investment income earned in a private corporation for tax years that begin after 2018. When in the previous year a corporation, and any associated corporations, earned in excess of $50,000 of adjusted aggregate investment income (AAII), the SBD limit will be reduced at a rate of $5 for every $1 of excess AAII, and will be fully eliminated once AAII reaches $150,000.

Where a corporation (or associated group) has a certain amount of active business income, it should endeavor to keep its AAII at or below the threshold that will allow it to use the appropriate amount SBD, if possible.

The incorporating your business reference guide discusses other potential constraints a corporation may face in accessing the SBD, notably excessive taxable capital, specified corporate income and the expanded deemed specified partnership income rules.

Associated Canadian controlled private corporations

As mentioned above, where two or more CCPCs are associated they must agree to allocate the $500,000 SBD 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 regarding how this might affect your professional corporation's ability to access the SBD, and what agreements, if any, should be filed with the corporations' tax returns allocating the SBD.

Corporations that are Partners

Where there is a partnership of professional corporations, the partnership income eligible for the SBD rate must be shared proportionately between the corporate partners on the basis of the partners' income allocations, with no possible discretionary allocation of the $500,000 SBD limit as with associated corporations. Therefore, as the number of partners in the partnership increases the amount of SBD to be allocated to each partner 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 SBD 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 SBD 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 shareholder 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

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.

PLANNING OPPORTUNITIES AND ISSUES

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, subject to the tax on split income discussed below. Income from a professional practice may fluctuate significantly from year to year, or you may at some point anticipate having lower income 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 potential tax deferral: your corporation deducts the amount in one year, but you might not 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, subject to the tax on split income discussed below.

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 in your province, 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.

The benefit of income splitting is eliminated when the Tax on Split Income applies.

Tax on split income

The tax on split income (TOSI) is an additional set of rules that must be considered when paying dividend from a private corporation to family members (or a trust for their benefit). The TOSI rules are a major impediment to income splitting with adult family members through private corporations and certain other structures.

To be clear, TOSI does not prevent dividends from being paid to other family members. Rather, the TOSI rules would generally be expected to prevent the family members from having the ability to have those dividends taxed at their own marginal rates, unless a TOSI exception applies, eliminating the benefit of income splitting.

Accordingly, TOSI is designed to dissuade you from having dividends paid to other family members, either directly or through a family trust. There are several exceptions (called excluded amounts) which will deem income to not be split income and therefore not subject to the

TOSI. When declaring dividends from a private corporation, you should consider whether any of these exceptions may apply to your situation.

1. You are at least 18 and you have been actively engaged on a regular, continuous and substantial basis[3] in the business in the current year (being the year the income item occurs).

2. You are at least 18 and you were actively engaged on a regular, continuous and substantial basis[4] in the business in any five prior years.

3. You are at least 25 and you own shares that have more than 10% of the votes and the value of the private corporation, provided the corporation:

   - has less than 90% of its business income for its last ended taxation year from the provision of services, and

   - is not a professional corporation, and

   - has less than 10% of the corporate income for its last taxation year derived directly or indirectly from another related business.

4. If you are at least 25 and the amount is reasonable in light of your contributions to the business relative to any other related person who has contributed to the business. In this regard the contributions to a business can be thought of in terms of:

   - A labour component represented by the functions the individual performs to support the business.

   - A capital component generally representing the individual having invested in the business, perhaps by way of purchase/subscription of shares or lending funds to the business.

   - A risk component in recognition of the risks the individual has taken in support of the business.

5. If you do not meet any of the above exceptions and if your spouse is at least 65, then if the amount you received had actually been received by your spouse and would have been exempt from TOSI if your spouse received it (due to meeting any one or more of the above exceptions), then the amount is exempt for you as well.

A detailed discussion of the TOSI rules and related exception is outside of the scope of this reference guide, but these rules should be considered in planning your share structure if you have any interest in income splitting with others, allowing other family members to work for your

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[3] If you worked at least 20 hours per week on average in the current year you are deemed to have met this requirement.

[4] If you worked at least 20 hours per week on average in any five prior years you are deemed to have met this requirement.

incorporated practice, your practice earns income from another family members' business, or if you will not be the sole shareholder of your business. Further information on TOSI can be found in our reference guide on tax on split income.

Complexity of share structure where a trust is 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.

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 might apply. Corporate attribution may deem you to receive a certain amount of interest income each year.

Note that the use of the corporate tax 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 and other anti-avoidance rules do not apply.

Capital gains exemption

One potential benefit of incorporating is access to the $883,384 (indexed) capital gains exemption (CGE). The CGE permits individuals to shelter up to $883,384 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. 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 qualify as 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. A professional corporation is an SBC where 90% of the fair market value of its assets are used in an active business carried on primarily in Canada. Also, for a period of 24 months before the determination time, the shares must meet a similar test, with a 50% active asset threshold applying.

Note that the use of the corporate tax deferral may also 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.

Potential for integration failure

When income is earned by a corporation and subsequently paid to its shareholders in the form of dividends, taxation applies at the corporate level and also at the shareholder level.

The tax rules provide complex tax integration mechanisms to ensure that income earned by a corporation and paid to its shareholders in the form of a dividend is ideally taxed at a similar overall rate as the same income earned directly by a shareholder.

In reality, integration is rarely perfect and as a result earning income through a corporation can result in an:

- ultimate tax savings (under-integration) or
- ultimate additional tax cost (over-integration or integration failure).

In the case of earning active business income, while occasionally there is an ultimate tax savings, typically an integration failure occurs. The rate of over/under-integration usually differs for income subject to the SBD rate versus the general active business rate.

When earning investment income through a corporation, be aware of the following:

- to prevent a large initial tax deferral from occurring the corporation is subject to some additional refundable corporate income taxes. These refundable taxes add to the corporation's refundable dividend tax on hand (RDTOH) accounts.
- there is generally a more pronounced ultimate tax cost5 compared to such income had it been earned personally.

The degree of over/under-integration varies by province and changes as personal or corporate tax rates/rules change.

[5] However, Canadian portfolio dividends tend to integrate perfectly.

OTHER TAX STRATEGIES

Should you need to buy a building as part of your practice, it may be cost efficient to have the corporation buy the building and make mortgage payments out of its income, which was taxed at the low small business rate, rather than out of your personal 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 normally still personally liable for claims arising from the provision of professional services (for example, negligence claims by patients or clients). Shareholders are normally 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 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 incorporating, such as those discussed above, will be available to you.

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APPENDIX A: MAXIMUM DEFERRAL BY PROVINCE IN 2020 USING SMALL BUSINESS DEDUCTION

Province	Provincial SBD Limit [6]	Highest Rate on an Individual's Income	Rate on Active Business Income up to $500,000	Maximum Deferral Using a Corporation
British Columbia	$500,000	53.5%	11.0%	$212,500
Alberta	$500,000	48.0%	11.0%	$185,000
Saskatchewan	$600,000	47.5%	11.0%	$182,500
Manitoba	$500,000	50.4%	9.0%	$207,000
Ontario	$500,000	53.5%	12.2%	$206,500
Quebec[7]	$500,000	53.3%	14.0%	$196,500
New Brunswick	$500,000	53.3%	11.5%	$209,000
Nova Scotia	$500,000	54.0%	11.5%	$212,500
Prince Edward Island	$500,000	51.4%	12.0%	$197,000
Newfoundland and Labrador	$500,000	51.3%	12.0%	$196,500
Northwest Territories	$500,000	47.0%	13.0%	$170,000
Nunavut	$500,000	44.5%	12.0%	$162,500
Yukon	$500,000	48.0%	11.0%	$185,000

[6] In provinces where the provincial SBD limit is above the $500,000 federal SBD limit, the maximum tax deferral illustrated assumes corporate income only up to the federal limit.

[7] In Quebec, if the business is not a primary sector, a manufacturing sector or does not employ sufficient employee-hours, Quebec's provincial small business rate will not apply.