Client Inc.: Tax Benefits Of Professional Incorporation

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By understanding the tax advantages of professional corporations, some value-added financial solutions are available for clients.

Who Can Incorporate?

While the rules vary by province (and territory), practicing members of most professions, such as law, medicine, engineering, architecture or accounting, can choose to incorporate. Under such an arrangement, the professional is an employee of the professional corporation, which, itself, carries on the business of the professional practice.

No Escaping Malpractice

Professional clients are reminded that the mere act of incorporating a professional practice will not absolve the professional from personal liability in the case of malpractice. In other words, a doctor cannot hide behind her corporation to avoid a malpractice lawsuit. On the other hand, the use of a corporation can indeed provide limited liability with respect to normal business dealings, such as trade payables, office space lease liabilities and bank loans that haven't been otherwise personally guaranteed.

Restrictions on Corporation's Activities

The legislation of most provinces restricts the activities that the professional corporation may carry on and limits the business of the corporation to the practice of the profession or "activities ancillary to the practice". That being said, the provinces generally permit the investing of surplus funds earned by the practice to be left in the corporation and be invested therein, providing a potentially significant tax deferral advantage (discussed below).

Reasons to Incorporate

There are various tax reasons why a professional may wish to incorporate: to realize an absolute tax savings, the potential for significant tax deferral, various income-splitting opportunities with a spouse/partner or adult children, or perhaps to ultimately take advantage of the lifetime capital gains exemption on the first $750,000 of gains on the sale of the practice (assuming this is permitted and feasible in the professional's province). Let's examine each of these opportunities in more detail.

Tax Savings

It may be possible for an absolute tax savings to be realized if non-deductible or even partly deductible expenses are paid for by the corporation as opposed to personally by the professional. To illustrate this, let's assume that Dr. Parker has a life insurance policy to provide for his family in the case of untimely death. His annual premiums total $1,000.

If Dr. Parker is not incorporated, he would have to earn about $1,818 from his professional practice in order to be able to pay the $1,000 insurance premium, assuming a top personal tax rate of 45 percent.

Now, assume Dr. Parker's practice was incorporated and the $1,000 insurance premium was paid by his corporation. In this case, to avoid a shareholder benefit issue, the corporation would be both the owner and corporate beneficiary of the policy. Upon Dr. Parker’s death, the death benefit less the adjusted cost basis of the policy would be credited to the professional corporation's notional "capital dividend account" and can then generally be paid out as a tax-free dividend to the estate.

Unless the bank required the insurance policy as collateral for a loan, the insurance premiums paid on the policy would not be tax deductible to his corporation. But, because the corporation is a Canadian controlled private corporation (CCPC) that can take advantage of the small business deduction on its first $500,000 of active business income, its theoretical corporate tax rate is 20 percent (the actual rate varies by province). Thus, the corporation only needs to generate $1,250 of professional pre-tax income, taxable at 20 per cent, to generate after-tax cash of $1,000 to pay the annual premium on the life insurance policy. In this example, having the corporation pay the annual life insurance premium instead of paying it himself, results in an annual savings to Dr. Parker of $568.

This is also a tax-effective way to pay partially deductible expenses, such as meals and entertainment that are incurred for business purposes of the corporation.

Tax Deferral

The use of a professional corporation has often been heralded as a great tax deferral mechanism, provided the professional "does not need all the cash" and can afford to leave some money in the corporation for investment purposes. The reason this works is that the professional corporation initially pays tax on its first $500,000 of corporate

income at the preferred small business tax rate. Since this rate is substantially lower than the top marginal personal tax rate, there can be a significant tax deferral advantage by leaving the after-tax corporate income inside the corporation as opposed to paying it out as a dividend immediately.

To illustrate this, let's take a look at an example of a dentist who earns $1,000 of professional income personally versus inside her professional corporation. The example assumes the $1,000 qualifies for the small business tax rate (say of 20 percent) and that the professional would otherwise be in a top personal marginal tax bracket of 45 percent.

The example below shows that, in both cases, $550 would remain after tax.

Professional income earned personally by dentist

Income	$1,000
Personal tax (@ 45%)	(450)
After tax cash	**$550**

Professional income earned by corporation

A) Income	**$1,000**
B) Corporate tax (@ 20%)	**(200)**
Net income	800
Dividend to shareholder	800
Gross-up	200
Taxable Dividend	1,000
Personal tax (@ 45%)	(450)
Dividend tax credit (25%)	200

** this combined rate may vary by province*

C) Net personal tax	**(250)**
After-tax cash (A-B-C)	**$550**

The advantage of earning the money inside a professional corporation is that there is a timing difference as to when the tax is paid. Note that if the dentist were to earn the $1,000 of professional income inside her corporation, the $250 of tax on the dividend.

(C) is not payable until the $800 dividend is paid out. In other words, if she doesn't need the money immediately, it can be retained and invested inside the corporation and approximately 25 per cent tax can be deferred until the amount is paid out as a dividend. Note that because of the wide difference in personal and corporate tax rates that exists provincially in Canada, the advantage of the deferral differs by province and may vary from 25 to 35 per cent on income taxed at the small business rate and left inside the corporation.

What about income above $500,000? Historically, the traditional advice is that the professional should not retain more than $500,000 inside the corporation since it would face a high rate of corporate tax. As a result, professionals were often encouraged to "bonus down" to this $500,000.

This rule of thumb, however, may no longer be valid given the enhanced dividend tax credit now available on income from private companies subject to full corporate tax rates. To elaborate, the 41% gross up on “eligible” dividends applies not just to public companies but also to private companies that have active business income above the $500,000 small business limit and that pay tax at full corporate rates not eligible for the small business deduction. Dividends paid from private companies from income taxed at the higher, full corporate tax rates are considered “eligible” dividends and are grossed up by 41% with the enhanced dividend tax credit available to reflect the higher level of corporate tax paid by the corporation on this active income. The net result is that even though the total tax paid on income not eligible for the small business rate but taxed inside the corporation at the higher rate and then paid out as an eligible dividend may be slightly higher than the personal tax otherwise paid on a “bonus,” there is still a significant tax deferral associated with leaving such funds in the corporation. The cost of the extra tax and value of the deferral varies by province and is dependent on how long the funds can remain in the corporation before needed. As a result, specific tax advice is warranted here.

Other considerations also need to be taken into account in determining the optimal salary dividend mix from the professional corporation. These could include paying sufficient salary or "earned income" to permit the professional to maximize his or her RRSP contributions. For example, a professional may have to pay herself at least $$127,611 of salary in 2011 to maximize her $22,970 RRSP deduction for 2012. Of course, whether a business owner should be contributing to an RRSP altogether is another matter, discussed in my recent report “Rethinking RRSPs for Business Owners.”

Income Splitting

There are a number of income-splitting opportunities available to professional corporations.

On the most basic level, income splitting could be achieved by employing the professional's spouse or common-law partner in the practice. The spouse could assist with billing and handle general office duties. In addition, the professional's kids could be hired with the caveat that they be paid a "reasonable" salary commensurate with their workload, age and responsibilities.

In provinces that permit non-professionals to be shareholders, more sophisticated income-splitting techniques can be employed such as paying significant amounts of tax-free dividends out of the professional corporation to a non-working spouse or partner who could use her basic personal amount and dividend tax credit to shelter these dividends from tax. For example, someone with no other source of income could earn nearly $50,000 in Canadian dividends without paying any federal or provincial tax depending on the province of residence.

Finally, some provinces also permit family trusts to hold shares. Provided that certain conditions are met, the professional income of the incorporated professional could be shared with the members of his or family who are beneficiaries of the trust.

Other Planning Opportunities

Non-Calendar Year-End

A professional corporation can choose a non-calendar year-end. By selecting a late year-end (after June 30th), the professional corporation can take advantage of the 180-day rule, which allows the corporation to pay a bonus to the owner and still claim a deduction in the corporation's current tax year while deferring the payment to the owner by 180 days so that it is not taxed until the following calendar year. For example, by choosing a July 31st year-end, a corporation can declare a bonus on July 31, 2011, and pay it within 180 days (e.g., in January 2012), thus deferring personal income tax on the bonus by six months.

Advanced Strategies

Finally, once the professional corporation has been established, it's now possible to consider additional tax planning opportunities and vehicles such as individual pension plans, retirement compensation arrangements and more complex corporate-owned life insurance solutions.

Setting up and maintaining a professional corporation requires knowledgeable legal and accounting advice. The tax benefits may be worth the cost and detail.

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