

Tax Planning for Real Estate Professionals

Tax Considerations of Incorporation

April 2023

In many provinces throughout Canada, self-employed real estate agents are able to incorporate and earn their commission income through a professional corporation, which allows them to benefit from potential personal income tax deferral and other tax planning opportunities available to other incorporated professionals, such as accountants, lawyers, and doctors. As a result of recent legislation,¹ those real estate professionals in Ontario who are considered independent contractors (versus employees) can also now benefit from incorporating in order to earn commission income in a corporate structure, similar to their counterparts in other provinces (including BC, Quebec, Alberta, Saskatchewan, Manitoba and Nova Scotia) who are currently allowed to incorporate.

Your provincial professional governing body or association has its own rules and standards that must be respected when allowing its members to practice through a professional corporation.² Other professionals – such as lawyers, accountants, engineers and architects – have the ability to incorporate their practices, to realize many tax and other benefits. This article provides a brief overview of the benefits of operating your real estate practice through a professional corporation and the possible implications of some important tax changes introduced several years ago. However, it's important to seek independent legal and tax advice regarding your particular situation.

Personal services business

A critical consideration in the incorporation decision is the ability to access the "small business deduction" ("SBD") which can depend on whether the corporation is considered a "personal services business" ("PSB"). This classification hinges on whether the incorporated individual is considered an employee or independent contractor. If a PSB exists, the SBD will not be available and only limited deductions can be made from the income of the corporation.

These restrictions could apply if an individual (such as a real estate agent) provides services as an employee through a corporation, rather than professional services. In general, a professional corporation may be considered to be carrying on a "personal services business" if the individual could be reasonably regarded as an employee of their client, but for the existence of the corporation.

The employee vs. independent contractor determination is ultimately a question of fact. The intention of the parties when they entered into the working arrangement is critical in this determination - i.e., did the two parties intend to enter into a contract of service (employer-employee relationship) or did they intend to enter into a contract for services (business relationship)? In addition, the Canada Revenue Agency ("CRA") has highlighted the following factors in this determination:

Control – This test relates to the degree of control exercised by the payer. If the service provider is an employee, the payer typically controls the service provider with respect to both the results of the work and the method used to do the work.

Ownership of tools – Self-employed contractors typically supply the tools and equipment necessary to perform the services required. As a result, the ownership of tools and equipment by a service provider is more commonly associated with an independent contractor relationship.

Financial risk – This test considers the degree to which the service provider will realize increased profits or suffer financial losses as a result of their activities.

Another important consideration is the number of clients serviced, as working only for a single client, particularly in an ongoing and long-standing relationship, could suggest a PSB determination. Ultimately, no one specific factor is determinative of the employee or independent contractor relationship and factors other than those listed above could apply, depending on the particular case. For further insight, please see the CRA publication, [Employee or Self-Employed](#).

Benefits of professional incorporation

Assuming that you are an independent contractor (vs. employee), you may be able to take advantage of certain tax and financial benefits by incorporating your real estate practice, such as:

Defer personal tax

Deferring personal income tax is one of the main reasons professionals incorporate their practices. Active business income retained in a professional corporation – which is not a “personal services business” as described above (i.e., an incorporated employee) – is taxed at either the small business corporate income tax rate,^{3,4} or the general corporate tax rate, both of which are significantly lower than the highest personal income tax rate. For example, in Ontario the combined Federal/provincial small business corporate tax rate for 2023 is 12.2 per cent on the first \$500,000 of earnings, and the combined general corporate rate is 26.5 per cent; whereas the combined top personal tax rate is 53.53 per cent.

By retaining a portion of your real estate commissions and other professional earnings within your corporation, you defer paying personal income tax until a later date when the funds are withdrawn. For example, if a real estate professional in Ontario retains \$200,000 of earnings within a professional corporation, income tax of up to approximately \$83,000 [(53.53 per cent minus 12.2 per cent) x \$200,000] can be

deferred until the funds are withdrawn.⁵ The deferral would be reduced to \$54,000 [(53.53 per cent minus 26.5 per cent) x \$200,000] if the professional corporation was not eligible for the small business deduction. The \$83,000 (or \$54,000) could be invested to generate additional investment income within the corporation.

However, tax changes originating from the 2018 Federal Budget will limit access to the small business deduction where a corporation or associated corporation(s) earns significant passive investment income, thereby reducing access to this tax deferral for taxation years that begin after 2018. Although these changes were somewhat less wide-ranging and dramatic than those originally proposed in the Federal government’s July 2017 Consultation Paper (which would have altered how investment income is taxed within a private corporation), these changes can impact many professional corporations.

Specifically, these measures will claw back the Federal small business deduction (available to the first \$500,000 of active business income) by \$5 for every \$1 of passive investment income above a \$50,000 threshold. These rules encompass any associated corporations; in essence any organization – or group of companies – with both active and passive sources of income. Accordingly, a professional corporation earning over \$150,000 of passive investment income itself or through an associated corporation, will no longer have access to the small business deduction and; therefore, would pay the higher general corporate tax rate. Notably, however, both the Ontario and New Brunswick governments did not parallel this Federal restriction, such that eligible Ontario and New Brunswick small businesses will continue to receive the relevant provincial small business deduction without a similar clawback for provincial tax purposes. Accordingly, for a professional incorporated in Ontario in 2023, the result will be a decreased tax deferral of up to \$30,000 [(18.2 per cent minus 12.2 per cent) x \$500,000], where \$500,000 or more of active business income is earned.⁶

The 2018 Federal Budget also introduced a second related measure affecting Canadian-controlled private corporations (“CCPC”) that seeks to limit access to a perceived tax advantage that a CCPC may realize when an eligible dividend is paid and refundable tax is recovered by the corporation.⁷

Income-splitting

Prior to the expansion of the “tax on split income” or “TOSI” rules, which are effective for the 2018 and subsequent taxation years, a professional corporation was often utilized by professionals to facilitate income-splitting with family members. This is because some provincial governing bodies allow professionals to include their spouse, children, and even parents as shareholders of their professional corporation, allowing dividends to be paid to them. To the extent that these family members (18 years of age or older) were taxed at lower marginal tax rates, the family’s overall tax bill was reduced.

However, effective January 1, 2018 a shareholder (of any age) of a professional corporation who does not meet specific exceptions will be subject to the expanded TOSI rules such that tax at the highest marginal rate will be applied on any dividends paid to them directly or through a family trust. Thus, the ability to split income and reduce the family’s overall tax bill will now be quite limited. The main exception available to a professional corporation is the “active engagement” of the family member shareholder(s) (aged 18 or over) in the business, in either the current year or any five preceding years. Guidance has been provided indicating that “active engagement” on a “regular, continuous and substantial basis” will generally constitute an average of 20 hours per week. In addition, if you are 65 or over your professional corporation will typically be able to pay dividends to your spouse without the application of TOSI.

In circumstances where family members do not meet the substantial labour exclusion described above, alternative compensation structures such as wages may still be available. Wages earned by family members are not subject to the TOSI rules, but in order to ensure wages paid are deductible to the private corporation for tax purposes, the wage expense must be reasonable in the circumstances. Please consult with your tax advisor to determine the possible impact to your particular situation, particularly in light of the complexity of these rules.

Remuneration flexibility

Establishing a professional corporation could provide a real estate professional with additional remuneration options. Many professionals choose to draw a sufficient salary from their corporation to allow them to contribute the maximum to their Registered Retirement Savings Plan (“RRSP”) each

year. If additional money is required to support their lifestyle, the corporation can pay out additional income in the form of dividends.

Another option, particularly for professionals aged 40 or over, is an Individual Pension Plan (“IPP”) – a defined benefit pension plan that is set up solely for your (or you and your spouse’s) benefit. An IPP allows you to increase your retirement assets, as higher contributions are allowed than what is permitted for RRSPs, and your professional corporation makes the tax-deductible contributions to fund the IPP. In light of the aforementioned tax changes limiting access to the small business deduction, this strategy may provide additional benefits.

Pay non-deductible business expenses from the corporation

Provided that a shareholder benefit would not result, it may be beneficial to have the professional corporation pay certain non-deductible business expenses such as life insurance premiums and entertainment expenses. Using corporate earnings – that are taxed at lower corporate rates compared to more costly personal after-tax dollars – is a more cost-effective way to fund these types of expenses, as less pre-tax income is needed to cover the expense.

Tax effective borrowing

If you would otherwise incur personal debt, such as a mortgage or a line of credit, you may instead be able to borrow funds from your corporation on a *short-term basis* at a cost that is lower than your current personal cost of financing the debt. When you take a shareholder loan from the corporation for this purpose, no immediate tax is payable; however, the loan generally must be repaid within one year after the end of the corporation’s taxation year in which the funds were drawn. If the loan is not repaid within this timeframe (or is repaid and subsequently re-advanced), it will be included in your income and subject to tax at your marginal personal tax rate.

However, it is important to note that there may be a deemed interest benefit taxable to you to the extent that the rate of interest paid by you to the corporation is less than the CRA’s prescribed rate. Visit the CRA site at <https://www.canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html> for the current prescribed rate.

Capital gains exemption

The capital gains exemption (“CGE”) for qualified shares of a small business corporation may be available on the sale of shares of the professional corporation or on the shareholder’s death, to a lifetime exemption of \$971,190 (for 2023). However, the shares may not be eligible where significant non-business assets have accumulated in the corporation, as certain asset and holding period tests must be met in order to qualify for the exemption. Also, the availability of the capital gains exemption may be limited for certain professionals who are typically unable to sell their practices. Even if a sale is possible, a purchaser would generally prefer to acquire the assets of a professional corporation rather than the shares.

Ask your BMO financial professional for a copy of our publication, *Tax Planning for Small Business Owners* for more information on the qualifying criteria for the CGE.

Asset protection

While a professional corporation does not mitigate professional liability (such as being sued for malpractice or negligence), it may provide some protection from business creditors who make claims against the professional corporation.

Other considerations

As a result of the aforementioned tax changes affecting private corporations, the tax benefits previously provided by professional corporations have been reduced. In addition, there are initial set up and ongoing tax filing and administrative costs, and complexities involved in establishing and maintaining a professional corporation, as well as payroll taxes in some provinces on remuneration.

Real estate professionals who are just starting their careers may spend the majority of their income establishing their practice, paying down debt and supporting their lifestyle. To the extent they are not yet profitable, any losses from an unincorporated business could be applied against personal income from other sources. In addition, as many of the (tax) benefits of incorporation depend on the profitability and retention of excess profits in the corporation, many young professionals just starting their careers may prefer to postpone incorporation until such time as they have surplus cash flow that can remain in the professional corporation.

Conclusion

Many provinces (including Ontario, as a result of recent legislative changes) allow real estate professionals to incorporate and earn commission income through a professional corporation, which offers many compelling tax benefits. However, there are other important considerations, especially in light of changes to the tax legislation affecting private companies. Because of the potentially reduced tax benefits and the additional complexities associated with a corporation (since each provincial governing body has its own rules and requirements), you are encouraged to consult with independent tax and legal advisors for direction in your particular circumstances.

For more information, please speak with your BMO financial professional.



¹ Trust in Real Estate Services Act, 2020 (“TRESA”), which is governed primarily by Regulation 536/20 under the Act. Note that the Ontario Real Estate Association (“OREA”) has compiled “A Guide to Personal Real Estate Corporations for Ontario REALTORS” and other helpful information to assist its members in understanding these new Personal Real Estate Corporation (“PREC”) regulations. See this [link](#) for further information.

² For example, Ontario legislation provides that only the real estate broker or salesperson registered with the Real Estate Council of Ontario (“RECO”) can be the voting/controlling shareholder of the PREC, however, non-voting shares of the PREC can be owned by family members (including a spouse, parent or child). Please consult with your provincial professional governing body or association for details in your province/territory.

³ The Federal small business deduction (“SBD”) applies to the first \$500,000 of income from an active business carried on in Canada by a Canadian-controlled private company (“CCPC”). It must be shared with associated CCPCs and may be clawed back for “large” corporations with taxable capital of associated corporate groups exceeding \$10M (and is completely eliminated when the associated group’s taxable capital exceeds \$50M, for tax years that begin on or after the 2022 Federal Budget date of April 7, 2022) or, as discussed herein, where the level of passive investment income in the corporation (or associated corporate group) exceeds \$50,000 annually. Similarly, the provinces and territories offer reduced rates, generally up to the first \$500,000 of active business income, except for Saskatchewan (\$600,000) for 2023. Quebec residents should take note of reduced eligibility for the provincial SBD, notably for corporations which are not in the primary or manufacturing sectors, unless the number of employee hours paid in the year by the corporation is at least 5,500 hours.

⁴ The tax legislation governing the small business deduction includes rules that are intended to preclude the inappropriate multiplication of access to the deduction. Amendments originating from the 2016 Federal Budget expanded these rules to address the government’s concerns about certain complex partnership and corporate structures that multiply access to the small business deduction.

The 2016 Federal Budget also introduced anti-avoidance rules to ensure that associated corporations cannot avoid the taxable capital limit and ensure that investment income derived from an associated corporation’s active business is ineligible for the small business deduction, in certain circumstances.

⁵ Assuming the professional earns sufficient taxable income from all sources to be otherwise subject to tax at the top marginal rate on this additional income retained in the professional corporation.

⁶ Assuming full clawback of the (Federal) SBD where passive income of \$150,000 or more is earned in the professional corporation or associated corporation(s). In other provinces which have paralleled the tax changes originating from the 2018 Federal Budget related to reduced access to the small business deduction, the impact is more pronounced. For example, in Alberta in 2023 the result is a decreased tax deferral of up to \$60,000 [(23 per cent minus 11 per cent) x \$500,000], where \$500,000 or more of active business income is earned.

⁷ Corporate tax on passive investment income earned is taxed at a rate that approximates the highest marginal personal income tax rates. A portion of this tax is refundable to the corporation when a taxable dividend is paid to a shareholder. Previously, a corporation received a refund of tax paid on investment income even when a lower-taxed (eligible) dividend, sourced from active income taxed at the general corporate rate, was paid. Effective for taxation years that begin after 2018, changes originating from the 2018 Federal Budget will allow a refund of the refundable tax only where a corporation pays a higher-taxed (non-eligible) dividend, except upon the payment of an eligible dividend where the refundable tax was sourced from the receipt of an eligible portfolio dividend.

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