Is a Professional Corporation Right For You?

In recent years, changes to provincial incorporation standards have made it possible for professionals to incorporate their practices or businesses and enjoy many of the same benefits as other self-employed incorporated individuals.

Your profession's governing body or association has its own rules and standards that must be respected when allowing its members to practice through a professional corporation. Professions allowed to incorporate include: doctors, dentists, veterinarians, lawyers, accountants, engineers and architects, as well as other professions that may also be allowed to incorporate, depending on the province. For example, in Ontario, social workers, social service workers and regulated health professionals can also incorporate.

Since many of your colleagues may already be operating their practices/businesses (practice) through a professional corporation, you may be asking yourself whether it makes sense to incorporate your own practice. This article provides a brief overview of the benefits of operating your practice through a professional corporation; however, it's important to seek independent legal and tax advice before establishing a professional corporation.

Benefits of setting up a professional corporation

By incorporating your practice, you can take advantage of certain financial benefits and opportunities.

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 is taxed at the small business corporate income tax rate,[1,2] which is significantly lower than the highest personal income tax rate. For example, in Alberta the small business corporate tax rate for 2016 is 13.5 per cent on the first $500,000 of earnings, whereas the top personal tax rate is 48.0 per cent.

By retaining a portion of your professional earnings within the corporation, you defer paying income tax until a later date when the funds are withdrawn. For example, if a doctor in Alberta retains $200,000 of earnings within a professional corporation, income tax of $69,000 [(48.0 per cent minus 13.5 per cent) x $200,000] can be deferred until the funds are withdrawn.[3] In addition, the $69,000 could be invested to generate additional investment income within the corporation.

It is important to note that the tax legislation governing the small business deduction includes rules that are intended to preclude the inappropriate multiplication of access to the deduction. The recent 2016 Federal Budget proposes changes to expand these rules to address the government's concerns about certain complex partnership and corporate structures that multiply access to the small business deduction. As these changes will affect professional corporations utilizing such structures, please consult with your tax advisor to determine the impact of these proposals, if any, to your particular situation.[4]

Professionals who are just starting their careers may spend the majority of their income establishing their practices, paying down debt and supporting their lifestyles. Depending on the extent of other benefits of professional incorporation, these individuals may prefer to postpone incorporation until such time as they have surplus cash flow that can remain in the professional corporation.

Income-splitting

Subject to your profession's provincial governing body or association, you can name your spouse, children and

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even parents as shareholders of your corporation. If these individuals are in a lower tax bracket, you could significantly reduce your family's overall tax bill by paying out dividends to these family members. Dividends paid to family members can be used for any purpose including covering education and eldercare costs or funding a new home purchase. However care must be taken to avoid the various income attribution rules and other provisions that can prevent income-splitting, such as the "kiddie tax," which can apply to dividends on professional corporation shares paid to children under the age of 18.

In addition, family members, such as spouses and children, may also be employed by your corporation and receive reasonable remuneration (on arm's length terms) for duties performed.

Remuneration flexibility

Establishing a professional corporation provides a professional with additional remuneration options. Often professionals will draw a sufficient salary from their corporations to allow them to contribute the maximum to their RRSPs each year. If additional money is required to support your lifestyle, the corporation can pay out additional income in the form of dividends.

Once you reach age 40 or older, you may want to consider establishing an Individual Pension Plan (IPP) – a company pension plan that is set up solely for your (or you and your spouse's) benefit. With an IPP you can 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.

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 have personal debt, such as a mortgage or a line of credit, you may 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 by the end of the calendar year following the end of the corporation's taxation year in which the funds were drawn; provided the repayment is not part of a "series" of loans and repayments. If the loan is not repaid within this time frame, it will be included in your income and subject to tax at your marginal personal tax rate.

There may also be a deemed interest benefit if the rate of interest paid by you to the corporation is less than the Canada Revenue Agency's (CRA) prescribed rate. Visit the CRA site at www.cra-arc.gc.ca/interestrates/ 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 $824,176 (for 2016). However, the shares may not qualify 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 as a purchaser would generally prefer to acquire the assets of a professional corporation rather than the shares. Ask your BMO Nesbitt Burns Investment Advisor for a copy of the article entitled "Tax Planning for the Family Business" 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.

An attractive business structure

There are initial set up and ongoing tax filing and administrative costs involved in establishing and maintaining a professional corporation, as well as payroll taxes in some provinces on remuneration. However, the income tax benefits provided by professional corporations make them an attractive business structure option for today's professionals. Many factors must be considered when deciding whether incorporation would be beneficial for your practice.

Talk to a professional

In light of the additional complexities associated with a corporation and since each province and professional governing body or association has its own rules and requirements, you are encouraged to consult with independent tax and legal advisors if considering a professional corporation.

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For more information, speak with your BMO Nesbitt Burns Investment Advisor.

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[1] 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 $15M). Although the 2015 Federal Budget proposed a 2% reduction in the federal SBD rates from the previous 2015 rate of 11% to 9% to be phased in equally from 2016 to 2019, the 2016 federal budget proposes to eliminate this phased-in reduction such that the federal rate remains at 10.5% for 2016 and subsequent years.

[2] Similarly, the provinces and territories offer reduced rates, generally up to the first $500,000 of active business income, except for Manitoba ($450,000) and Nova Scotia ($350,000) for 2016. Quebec residents should take note that recent Quebec budgets have proposed reduced eligibility to the provincial SBD, notably for corporations which are not in the primary or manufacturing sectors, unless the minimum number of hours worked in the year by employees of the corporation is 5,500 hours, effective for taxation years beginning after December 31, 2016.

[3] 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.

[4] The 2016 federal budget also introduced anti-avoidance rules to ensure that associated corporations cannot avoid the $15 million 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.

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