Is a Professional Corporation Right For You?

Many professionals incorporate their practices to enjoy the same benefits as other self-employed incorporated individuals. However, recent tax proposals affecting Canadian private corporations can have significant implications to professional corporations that will impact the decision to incorporate.

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.

Since many of your colleagues may already be operating their practices through a professional corporation, you may be asking yourself whether it makes sense to incorporate your own practice; especially in light of the recent tax proposals. 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 (which is not a "personal services business" – i.e., an incorporated employee) is taxed at either the small business corporate income tax rate,[1,2] or the general corporate tax rate, both of which are significantly lower than the highest personal income tax rate. For example, in Alberta the combined small business corporate tax rate for 2018 is 12 per cent on the first $500,000 of earnings, and the combined general corporate rate is 27 per cent, whereas the combined top personal tax rate is 48 per cent.

By retaining a portion of your professional earnings within the corporation, you defer paying personal income tax until a later date when the funds are withdrawn.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corporation, income tax of $72,000 [(48 per cent minus 12 per cent) x $200,000] can be deferred until the funds are withdrawn.[3] The deferral would be reduced to $42,000 [(48 per cent minus 27 per cent) x $200,000] if the professional corporation was not eligible for the small business deduction. The $72,000 (or $42,000) could be invested to generate additional investment income within the corporation.

However, proposed tax changes originating from the 2018 Federal Budget seek to 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.

Specifically, the recent Federal Budget measures propose to 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. Accordingly, for $150,000 of passive investment income, a corporation would no longer have access to the small business deduction, and therefore would pay the higher general corporate tax rate. These rules will also apply to 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. For an incorporated professional in Alberta, the result will be a decreased tax deferral of up to $75,000 [(27 per cent minus 12 per cent) x $500,000], where $500,000 or more of active business income is earned.[4]

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.[5] Please see our BMO Wealth Management publication entitled, **2018 Federal Budget Review,** for more information regarding these two proposals.

Income-splitting

Prior to the recent expansion of the 'tax on split income' or 'TOSI' rules, proposed to be effective for the 2018 and subsequent taxation years, a professional corporation was often utilized to facilitate income-splitting with family members. Subject to the specific rules of your profession's provincial governing body or association, it may be possible to include your spouse, children and even parents as shareholders of your corporation, which allows 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 any shareholder 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 5 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 any current or proposed 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.

The 2018 Ontario Provincial Budget indicated that the province intends to parallel the federal proposals related to both income-splitting and reduced access to the small business deduction. It is expected that most other provinces will also parallel these federal proposals. However, you should consult with your tax advisor to determine the possible impact to your particular situation, especially in light of the complexity of these new rules.

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 defined benefit 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. In light of the aforementioned recent 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 time frame (or is repaid and subsequently re-advanced), it will be included in your income and subject to tax at your marginal personal tax rate.

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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 $848,252 (for 2018). 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 financial professional for a copy of our article entitled, **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.

Still an attractive business structure?

As a result of the proposed measures affecting private corporations, the tax benefits previously provided by professional corporations may be significantly reduced. In addition, 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.

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. When deciding whether incorporation would be beneficial for your practice, it will be important to weigh all of the relevant considerations.

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In light of reduced tax benefits and the additional complexities associated with a corporation, and because 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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[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) 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) and Manitoba ($450,000) for 2018. Quebec residents should take note of 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.

[2] 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 $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.

[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 illustration assumes that Alberta parallels the 2018 Federal Budget proposals related to reduced access to the small business deduction.

[5] 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. Currently a corporation receives 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, is paid. The 2018 Federal Budget proposes to 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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