

TAXTALK

PROFESSIONAL CORPORATIONS IN ONTARIO

Recent corporate tax rate reductions, enacted and proposed, make it an excellent time for professionals to consider incorporating their practices. The low corporate tax rate of 18.62% available to corporations in Ontario is now available on the first \$400,000¹ of active business income, providing more flexibility in remuneration strategies.

Incorporation also provides the ability to access the capital gains exemption. The capital gains exemption allows the professional to potentially realize tax-free capital gains on the disposition of shares of the professional corporation. The 2007 federal budget proposed to increase the current lifetime capital gains exemption from \$500,000 to \$750,000 effective for dispositions occurring on or after March 19, 2007.

For physicians and dentists, the benefits of incorporation have been further enhanced with legislative changes introduced in 2006, which allow family members to hold non-voting shares of their professional corporation. The ability for the professional's family members to hold shares in the professional corporation provides for some income-splitting opportunities (via dividends), as well as multiplying access to the capital gains exemption.

As with any tax planning opportunity, there are advantages and disadvantages to incorporating a business, and each case is often a complex decision based on business and personal circumstances. This TaxTalk discusses the pros and cons of incorporation and will be of interest primarily to those *professionals who are considering incorporation of their practice.*

¹ Effective January 1, 2007.

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Incorporating Professionals - A Little History

Prior to 2001, the only professionals allowed by their governing bodies to incorporate were architects, engineers and pharmacists. On November 1, 2001, Ontario proclaimed into law amendments to allow the following professionals to incorporate:

- medical and dental professionals named in Schedule 1² of the Regulated Health Professions Act, 1991,
- Certified General Accountants
- Chartered Accountants
- Lawyers
- Social Workers,
- Social Service Workers, and
- Veterinarians.

² Schedule 1 of the Regulated Health Professions Act, 1991 covers audiologists, chiropractors including podiatrists, chiropractors, dental hygienists, dental surgeons, dental technologists, denturists, dieticians, massage therapists, medical laboratory technologists, medical radiation technologists, midwives, nurses, occupational therapists, opticians, optometrists, pharmacists, physicians and surgeons, physiotherapists, psychologists, speech language pathologists, respiratory therapists, and traditional Chinese medicine practitioners and acupuncturists.

Incorporation

Professional corporations (PCs) in Ontario are governed by the Ontario Business Corporations Act (OBCA), as well as the by-laws of the respective profession's governing body. In addition to obtaining Articles of Incorporation under the OBCA, the professional must receive approval from the relevant governing body of the profession to practice in a PC. Approval must be granted by the issuance of a Certificate of Authorization or other authorizing document before the professional can begin practicing in the PC. This approval process will vary in accordance with each profession's governing by-laws. Annual renewal of the Certificate of Authorization may be required.

The OBCA also requires that the corporate name include '*Professional Corporation*'³. The PC cannot have a numbered name, and its officers and directors must be members of the profession.

The requirements of the respective governing body should also be reviewed before the incorporation process begins to ensure that they are complied with.

Business Activities

The OBCA restricts the activities carried on by the PC to the professional practice, with certain exceptions. These exceptions include those activities *related* to the profession (this exclusion allows a dentist to practice dentistry and dental hygiene in the same PC), as well as those activities *ancillary* to the practice, including the investment of surplus funds earned by the PC.

Activities are generally considered to be ancillary to the practice if they are incidental to the main business of the PC. To date, little guidance has been provided as to when an activity would no longer be considered ancillary to the practice.

Share Ownership

As Introduced in 2001

When first introduced in 2001, the OBCA specified that only members of the same profession could be shareholders of a PC. Multi-disciplinary PCs were, and are still, *not* permitted. This rule precludes, for example, a dentist and a dental hygienist from each owning shares in one PC and carrying on the business of dentistry and dental hygiene in the same corporation.

³ Or 'Société professionnelle'.

In addition, family members⁴ were not permitted to hold shares in the PC, thereby denying professionals some of the tax benefits available to other corporate business entrepreneurs.

New Rules for Physicians and Dentists

Effective January 1, 2006 the OBCA was amended to permit certain family members of a physician or dentist to hold non-voting shares of the PC. This amendment now provides physicians and dentists the opportunity to income-split and multiply access to the capital gains exemption with family members. Under the amended legislation, a family member includes the spouse, children or parents of the professional.

Specifically, non-voting shares may be held by the professional, by a family member of the professional or in trust for a minor child who is a family member of the professional. It appears that shares held in trust for a minor child must be distributed to the child, when the child reaches the age of 18.

Use of a Holding Company

For private companies, it is often prudent to establish a holding company for tax planning and creditor proofing. However, it appears that the benefits associated with a holding company are limited to only certain professionals⁵.

It is our understanding that the Law Society of Upper Canada allows lawyers to own shares in a holding company⁶, which in turn holds shares in the PC. However, the governing bodies for physicians, dentists, veterinarians and chartered accountants will *not* allow a holding company to own shares in a PC; the shares of the PC must be owned directly by the professional.

Tax Benefits of Incorporation

Incorporating a professional practice has its advantages, with the most compelling arising from the potential tax benefits: the deferral of income taxes, possible access to the capital gains exemption, and more recently for physicians and dentists, the potential to income-split with certain family members.

⁴ Except members of the same profession.

⁵ The wording of the OBCA provides for direct or indirect ownership of shares by the professional. There is some debate whether a professional, who owns shares in a holding company which in turn holds shares in the PC, can be considered to own the shares of the PC, or whether the professional merely has a right to the underlying equity of the holding company, which owns the PC.

⁶ The lawyer must hold all the shares of the holding company.

Tax Deferral by Accessing Low Corporate Tax Rates

Perhaps the most obvious tax incentive to incorporate is the ability to benefit from the small business deduction (SBD). In Ontario, the first \$400,000⁷ of active business income earned annually by a corporation is eligible for the low corporate income tax rate, which for 2007 is 18.62%. This rate is significantly lower than the current top marginal tax rate applicable to an individual resident in Ontario of 46.41%⁸. As such, incorporation can provide a *deferral* of \$27.79 of income tax on each \$100 of income retained by the PC.

If the professional is not personally spending most or all the income from their practice annually, the 18.62 % small business rate will provide the PC with more “after tax dollars” with which to “finance” operations, i.e., to repay existing corporate debt and/or purchase capital assets. The PC will also have more “after tax dollars” to finance non-deductible expenses, (e.g. certain membership or club dues) or those expenses for which the tax deduction is limited to 50%, such as meals and entertainment.

For example, a professional (with no other sources of income) earns net income of \$560,000 in the practice in 2007, but only requires \$100,000 personally. The first \$160,000, paid out as salary from the PC to the professional, would be subject to approximately \$60,000 of personal income tax, providing the professional with after tax cash of approximately \$100,000 to fund personal expenditures.

After paying the \$160,000 salary, the PC would have \$400,000 of income subject to tax. The PC would pay *corporate* income tax of \$74,480 on the remaining \$400,000 of income. This corporate income tax is substantially less than the *personal* income tax of \$185,640 that the professional would otherwise pay, if the additional \$400,000 is income from self-employment⁹. In this case, the PC will have \$111,160 additional after-corporate tax dollars, than if the professional earned the \$400,000 of net income directly.

Tax Savings via a Corporation

In addition to the tax deferral, there is also currently a tax savings to earning \$400,000 of income through a PC.

⁷ The federal SBD income threshold is \$400,000 for companies with a December 31, 2007 year-end. For companies with 2007 year-ends other than December, the federal SBD threshold is prorated to be between \$300,000 and \$400,000. The \$400,000 SBD must be shared by associated corporations.

⁸ For 2007, the top marginal income tax rate of 46.41% applies when taxable income exceeds \$120,887.

⁹ Either from a sole proprietorship or partnership.

Continuing with our illustration, when the professional withdraws the \$325,520 of retained earnings (i.e. receives dividend income) from the PC, the professional will be subject to *personal* income tax of \$102,018¹⁰. Thus, in this example, the total corporate and personal tax cost of earning the \$400,000 in the PC and then distributing the after tax earnings to the professional would be \$176,498.

Consequently, to the extent the professional withdraws the after tax earnings from the corporation, the benefit of the low corporate income tax rate is diminished. There is, however, still an ultimate annual tax savings of up to \$9,142 per year (or 2.29%) to earning up to \$400,000 of active business income in a PC and paying it to the professional as dividends, as compared to the professional personally earning the income from self-employment.

The chart below illustrates the annual tax deferral and tax savings on the additional \$400,000 of professional income earned in the PC, and then paid to the professional.

Illustration of Potential Annual Deferral/Savings (using 2007 income tax rates applicable in Ontario)		
Professional earns additional \$400,000 and pays tax at top marginal personal tax rate		
Income (from self employment)		\$400,000
Income tax at 46.41%	(a)	<u>(185,640)</u>
Net income retained by professional		<u>214,360</u>
PC earns additional \$400,000 and pays tax at low corporate tax rate		
Income (in corporation)		400,000
Income tax at 18.62%	(b)	<u>(74,480)</u>
Net income retained by PC		<u>325,520</u>
Tax deferral of 27.79%	(a-b)	<u>111,160</u>
Dividend from PC to professional		
Income tax at 31.34%	(c)	<u>(102,018)</u>
Net income retained by professional		<u>223,502</u>
Combined income tax of 44.12%	(b+c)	<u>176,498</u>
Tax savings¹¹ of 2.29%	(a) - (b+c)	<u>\$ 9,142</u>

¹⁰ We have assumed that the professional is in the top marginal income tax bracket in the year the dividends are received, i.e. the professional's taxable income exceeds \$120,887. The rate is based on the 2007 top marginal rate applicable to dividend income of 31.34%. If the professional receives dividends in a year he/she is subject to a lower rate of tax, the income tax will be less and therefore, the benefit of incorporation will be greater.

¹¹ There are other considerations when determining whether or not to pay a dividend or salary. These considerations are reviewed in our Year End Tax Planning TaxTalk.

The low corporate rate of 18.62% may decrease in future years, if the scheduled increase in the federal small business deduction rate and elimination of the federal surtax are introduced. The proposed rates of 17% and 16.5%, for 2008 and 2009 respectively, would potentially increase the annual tax savings of paying corporate tax on earnings and then paying dividends to the professional by an additional \$4,500 to \$5,800 per year.

The small business rate of 18.62% is only available on the first \$400,000 of active business income¹². If taxable income of the corporation exceeds the small business limit, a reduction of the Ontario small business deduction may occur, eroding the tax deferral benefit and reducing (or completely eliminating) the Ontario tax savings. Therefore, corporate income exceeding \$400,000 is generally paid out to the professional as a salary or bonus to ensure the maximum (combined corporate and personal) income tax rate does not exceed the top marginal tax rate the professional would otherwise incur.

Capital Gains Exemption

Another attractive feature of incorporating is the capital gains exemption¹³ which may be available to a professional on the disposition (or deemed disposition¹⁴) of shares of the PC. The capital gains exemption can reduce or eliminate the income tax on the disposition.

The capital gains exemption is available in respect of the disposition of qualified small business shares. For a professional at the top marginal rate, currently 46.41%, and based on the proposed increased lifetime capital gains exemption of \$750,000 this could result in potential income tax savings on the capital gain of up to \$174,000.

For physicians and dentists, the potential savings may be exponential. Each family member (including minor children), holding equity shares in an eligible PC with unrealized gains, may be able to claim the capital gains exemption at the time of disposition of the shares of the PC.

¹²The corporate tax rate on any excess corporate income from \$400,001 to \$1,128,529 (subject to the Ontario clawback) is 40.79%, and thereafter is generally 36.12%.

¹³A detailed discussion of the capital gains exemption and potential restrictions is beyond the scope of this TaxTalk. Please refer to our Year End Tax Planning TaxTalk for added details.

¹⁴A deemed disposition could occur on emigration from Canada or on the death of the professional.

Whether or not the capital gains exemption can be accessed will depend on several factors, such as:

- whether the shares meet the criteria to be eligible for the exemption,
- if the shareholder has any personal impediments which may limit or eliminate the ability to utilize the exemption,
- whether a market exists for the shares, and
- how much the share price would be discounted (as opposed to the sale of assets) for possible unknown corporate liabilities, and to compensate the buyer for not obtaining an increase in the cost base of the underlying corporate assets purchased.

Prospective purchasers interested in acquiring shares of the PC may be limited. For example, given the current shortage of available physicians, they commonly prefer to setup new practices versus purchase existing practices. Therefore, in today's market a physician may have difficulty selling their practice, whether incorporated or not. The OBCA requires that the shares must be held by members of the profession (or family members, in the case non-voting shares of the PC of a physician or dentist), precluding non-members of the profession as potential purchasers of the shares.

As well, the governing bodies of most professions will not allow a holding company to be interposed between the professional and the PC. Thus, the buyer may not be able to set-up a holding company to buy shares, and may have to fund their purchase with personal after-tax dollars rather than with corporate after-tax dollars. As illustrated above, on the same income, the professional will have substantially less after-tax dollars, than the corporation would have. For example, to generate the after tax dollars required to fund the acquisition of a \$500,000 practice, a top tax rate professional would need to personally earn pre-tax income approximately \$933,000, while the corporation would only need to earn pre-tax income of \$615,000.

Income-Splitting

A) Share Ownership — for physicians and dentists

As noted earlier, for physicians and dentists the opportunity to income-split became a reality with the amendments to the OBCA in 2006 allowing family members to hold *non-voting shares*. Although family members who hold shares in the PC will not be able to vote, they will be able to receive dividends. To the extent that the family member receives dividends from the PC and is subject to a marginal income tax rate lower than the rate of the professional, tax savings will be realized.

Since dividend income received by a minor child from a PC will be subject to the “kiddie tax”¹⁵, increased income-splitting benefits with children start once the child reaches the age of 18....just in time for all those post-secondary expenses.

The benefit of income-splitting can be best illustrated by an example. Let us say the professional in our previous example is a physician who wishes to incorporate. The physician’s spouse and three children (ages 18, 20 and 22) have no other significant sources of income. The PC, after paying a salary of \$160,000 to the professional, has \$400,000 of income from the practice. The PC would pay corporate income tax of approximately \$75,000, leaving \$325,000 in after tax earnings to pay to its shareholders. The chart below illustrates the income tax that the family would be subject to, if the dividend of \$325,000 is paid as follows:

Dividend Recipient	Dividend Received	Estimated Income Tax
Professional	\$175,000	\$55,000
Spouse	60,000	5,000
Child 1	30,000	400
Child 2	30,000	400
Child 3	30,000	400
Total	\$325,000	\$61,200

If the full \$325,000 dividend were instead paid to the professional and subject to tax at the top marginal rate, the professional would be subject to income tax of approximately \$102,000 as compared to \$61,200 per above. In this example, paying dividends of \$150,000 on the non-voting shares held by family members (rather than on shares held by the professional) would reduce the family tax burden by \$40,800.

Although the potential income tax savings from income splitting with a spouse and/or a child is very attractive, it is important to consider additional factors such as:

- What rights should the non-voting shares (and therefore the non-voting shareholders) have?
- Is the child mature enough to handle the income he/she will receive?
- How much of the future growth should attribute to the shares of the professional, spouse, or child?
- How likely is it that the child may emigrate from Canada?

These issues should be addressed in the planning process.

¹⁵The “kiddie tax” imposes a higher rate of income tax on minor children on certain types of income received by the child. A detailed discussion of the “kiddie tax” is beyond the scope of this TaxTalk.

B) Other Options — for all professionals

Alternatively, family members, including family members under 18 years of age, may be employed by the PC and receive reasonable salaries (based on the work performed) with respect to their involvement in the business.

A management, technical services corporation or partnership formed by family members may represent another alternative to facilitate income splitting¹⁶.

Other Tax Considerations

Attribution Rules

If an individual gifts or loans property to their spouse or to a minor child, with whom they do not deal at arm’s length (including a niece or nephew), the income earned or realized from the property will be attributed back to (i.e. taxed in the hands of) the individual, who gifted or loaned the funds. For spouses the attribution rules extend to capital gains i.e., to attribute capital gains to the transferor spouse.

To ensure that income/capital gains are not subject to the attribution rules, it is important that the spouse or minor child pay fair market value for the shares and that they use their own funds to acquire the shares of the PC. With proper planning, common shares can be issued to the spouse and/or children for nominal consideration.

Transferring the Practice to the PC

It is essential to consider all of the tax implications of incorporating, including any potential income tax, goods and services tax (GST), Ontario provincial sales tax (PST) or land transfer tax (LTT) that may be payable on the transfer of assets to a corporation.

Most transfers of property to an individual, corporation or trust are taxable events, and subject to income tax. However, transfers of certain assets to a corporation can occur on a tax-deferred basis if a tax election form¹⁷ is filed on a timely basis. Therefore, the transfer of the professional practice to a PC can generally be accomplished on an income tax-deferred basis.

¹⁶A detailed discussion of these alternatives is beyond the scope of this TaxTalk.

¹⁷The tax election form can be filed to allow asset transfers to the PC to occur at their ‘cost’ for income tax purposes.

In most cases, the transfer of a business can occur without attracting GST, if the appropriate GST election form is filed. There are exceptions:

- Real property (including leasehold interests) is subject to GST on the transfer of a business by a non-registrant where the supply of goods and services are exempt from GST (such as a physician or dentist) to another non-registrant, and
- All assets transferred from a registrant to a non-registrant are subject to GST.

The transfer of the assets of a practice to a PC is generally exempt from PST under the related party exemption rules.

Real property used exclusively in a family owned business that is transferred to a “wholly family owned” corporation is generally exempt from LTT if business operations are continued in the PC. If the transaction does not meet this exemption, LTT will apply on the transfer of any real property to the PC¹⁸.

Access to the Small Business Deduction

There are a number of situations which may affect access to the special low rate on the first \$400,000 of income in the PC:

- if several professionals become shareholders in one PC, their ability to benefit from the \$400,000 small business deduction may be proportional to the percentage of their shareholdings; the tax savings for each professional may be insignificant.
- access to the small business rate may be limited if the PC is associated¹⁹ with other corporations. In this case, the PC must share the \$400,000 small business limit with the other associated corporations.
- if PCs are structured as members of a partnership, the corporate partners may be required to share the \$400,000 small business limit with respect to the taxation of the partnership income.²⁰

Before incorporating, it is advisable to consult with a tax advisor to ensure planning opportunities are taken advantage of to maximize access to the small business deduction.

¹⁸It may be prudent *not* to transfer the real estate to the PC if LTT is to be incurred.

¹⁹Association generally occurs when one corporation controls another corporation or a person holds at least 25% of the any class of shares in two corporations, each of which is controlled by other persons that are related to that person. Corporations may also be deemed to be associated under other general anti-avoidance rules.

²⁰There are possible planning opportunities whereby professionals who are members of a partnership and wish to incorporate will not have to share access to the low rate of tax.

Application of Business Losses

Although business losses realized by a self-employed individual can be applied against other sources of their income, the losses of a PC are locked within the corporation. These losses may, however, be carried back up to three years, and forward up to twenty years to be claimed against income of the corporation in the carryover years.

Timing

It will be necessary to determine the optimal time to incorporate, as well as the optimal year-end for the new corporation.

Other

Other issues/potential opportunities that may need to be addressed include:

- optimal salary/dividend mix to the owner managers;
- payroll taxes;
- employee profit sharing plans, individual pension plans, and; retirement compensation arrangements,
- shareholder benefits; and
- tax instalments; personal and corporate.

Professional Liability

Incorporation generally provides protection to the shareholder from corporate liabilities, over and above the shareholder’s investment in the corporation and any personal guarantees provided by the shareholder. Although a PC may provide limited liability protection to its shareholders with respect to commercial liabilities (ie. trade payables, non-guaranteed bank loans, lease liabilities, etc.) and other business activities ancillary to the practice, it affords *no protection* to its shareholders for professional malpractice claims against the PC.

In this regard, the OBCA essentially provides that:

- the acts of the PC are deemed to be acts of the shareholders, employees or agents,
- a professional member’s professional liability is not affected by practicing in a PC, and
- shareholders of the PC, who are members of the profession, are jointly and severally liable with the corporation for any professional liability claims made while they are a shareholder.

Certain governing bodies, such as the Law Society of Upper Canada and the Institute of Chartered Accountants of Ontario, allow members to practice in a limited liability partnership (LLP). An LLP limits professional liability to each partner's own actions and those employees or agents under their supervision. The LLP thereby limits the professional's exposure to malpractice suits to their own actions; and insulates the professional from the actions of their partners.

The Law Society of Upper Canada allows lawyers in an LLP to 'roll' (transfer on a tax-deferred basis) their partnership interest in the LLP into a PC. Effective May 18, 2006 the Chartered Accountants Act, 1956 was amended to allow chartered accountants to hold their LLP partnership interests in a PC.

During the planning process, legal counsel should be consulted to determine which business structure will best address liability concerns.

Non-Tax Considerations

In addition to the usual array of tax considerations, there are also a number of non-tax considerations which should be reviewed prior to incorporation. One must consider the initial legal and accounting costs of incorporating, as well as the ongoing legal, accounting and administrative costs to maintain a corporation.

With regard to the incorporation of a practice, where the assets (and operations) of a practice are being transferred to a PC, many administrative matters must be dealt with, including the following:

- obtain a valuation of the practice;
- register for federal business numbers including income tax, GST, payroll and excise, as required;
- register for provincial business numbers, as required;
- register with the Workplace Safety and Insurance Board, as required;
- obtain consent, as required, from bankers, landlord, equipment lessors, and major creditors;
- notify insurers;
- change the firm name on financial accounts, business signs and telephone listings;
- order new stationery, business cards, invoices;
- consider the impact on payroll, EI and CPP withholdings required for employees otherwise reaching the maximum;
- administer changes to employee group plans;
- set up separate books and records for the PC, and
- in the case of a PC with multiple shareholders, determine the methodology to administer "admission" and "departure" of shareholders.

Summary

There are many advantages to the incorporation of a professional practice. With the recent changes which allow family members to own shares of, and receive dividends from, PCs for physicians and dentists, the attraction for those professionals to incorporate has increased. A decision to incorporate should only be made after the pros and cons are reviewed with your professional advisors, taking into account your personal situation. If a decision is made to incorporate, then it is important to properly set up and operate the PC to ensure it complies with applicable rules and regulations of the profession.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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