

TaxTalk

PROFESSIONAL CORPORATIONS

Prior to recent legislative changes, many professionals located in Ontario were unable to operate their business/profession in an incorporated entity. With these changes, many professionals may now incorporate. As with any tax planning opportunity, there are advantages and disadvantages to incorporating, and each case will differ. This TaxTalk will discuss the pros and cons of incorporation and will be of interest to those professionals who are now, or soon will be, allowed to incorporate.

Introduction of Legislation and By-laws

Certain professionals have been allowed to incorporate provided that the Act governing their profession expressly allowed incorporation. For example, architects, engineers and pharmacists have all been allowed to incorporate in the past.

In the 2000 Ontario budget, the government proposed to allow the incorporation of other professionals. The expanded list of professions allowed to incorporate now includes medical and dental professionals named in Schedule 1¹ of the Regulated Health Professions Act, 1991, as well as professionals governed by the Certified General Accountants Association of Ontario Act, 1983, The Chartered Accountants Act, 1956, the Law Society Act, the Social Work and Social Service Work Act, 1998 and the Veterinarians Act.

Although the legislation received Royal Assent on December 21, 2000, it was not proclaimed into law until November 1, 2001, so incorporation was not possible until after November 1, 2001.

¹ Schedule 1 of the Regulated Health Professions Act, 1991 covers audiologists, chiropodists 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, and respiratory therapists.

In order to carry on a business/profession, a professional corporation must hold a valid certificate of authorization or other authorizing document issued under an Act governing its profession. This requirement necessitates each of the professional governing bodies to enact by-laws to accommodate incorporation. To date, these by-laws have been enacted for chartered accountants, certified general accountants, lawyers, veterinarians, and dentists, allowing them to incorporate². Other professions are in the process of drafting requisite by-laws etc., including the Royal College of Physicians and Surgeons of Ontario (expects to have their forms available in October 2002), and the College of Social Workers and Social Service Workers.

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² Each health professional should confirm with the respective college to determine when by-laws will be in place.

Incorporation

The professional must request approval to incorporate from the relevant institute/college/society. The type of approval will vary with each profession's by-laws.

Some of the requirements to be met include:

- "Professional Corporation" must be included in the name of the corporation,
- only members³ of the profession may own (legally and beneficially), directly or indirectly, the shares of a professional corporation,
- all shareholders must be of the same profession,⁴ and
- only shareholders of the corporation may be officers and/or directors.

Business Restrictions

The corporation's business is restricted to the practice of the profession. Any other activity must be ancillary to the professional practice, including the *temporary investment of surplus funds earned by the corporation*. To date, no guidelines have been established to distinguish at what point the investment of funds would no longer be considered ancillary to the practice, but rather be considered a separate business. Without guidance, it will be difficult to know how much of the after-tax income of the professional company can be retained in the form of investments. It is hoped that this issue will be soon addressed and appropriate criteria established.

Potential Benefits of Incorporation

Generally an individual will incorporate for the following reasons:

- to provide the protection of **limited liability**, and
- to enjoy certain **tax advantages**, such as the lower corporate income tax rates available on income earned from an active business, the potential benefit of the capital gains exemption on the disposition of shares, and the potential to split income with family members.

Not all of these benefits are available to a professional corporation, as discussed in more detail below.

³ The fact that only members of the profession can own shares seems to preclude other entities, such as trusts, partnerships or corporations from holding shares.

⁴ i.e. the legislation does not allow for multi-disciplinary corporations.

Liability of Professionals

A professional corporation **does not limit the professional liability of its shareholders and could lead to increased liability** for partners who are currently members of a Limited Liability Partnership ("LLP"). Acts of the professional corporation will be considered to be acts of/by the shareholders, employees or its agents. A shareholder of a professional corporation is **jointly and severally liable** for all professional liability claims made with respect to errors and omissions occurring during the period he/she owns shares in the professional corporation. Therefore, for liability reasons, partners of an LLP⁵ may not want to "trade in" their partnership interests for a proportionate number of shares in a professional corporation.

It may be possible for partners to enjoy the benefits of incorporation as well as the limited liability benefits of an LLP. Each partner could hold shares in his/her professional corporation, which in turn would hold an interest in an LLP. However, before proceeding in this regard, legal advice should be obtained to ensure that personal liability is indeed restricted, and the structure does not offend the by-laws of the respective profession. Costs to set up and administer must also be considered.

Amendments to the legislation for professional corporations do **not** expose the shareholder of a professional corporation to **commercial liabilities**. For example, if a professional corporation was liable for a bank loan, which it was unable to pay, the banks recourse should be limited only to the net assets of the professional corporation; that is, the shareholder should **not** be personally liable (assuming that the shareholder has not personally guaranteed the corporate debt).

Tax Considerations

As indicated, there can be tax advantages to incorporating a profession.

Low Corporate Tax - Small Business Deduction⁶

Perhaps the most obvious tax incentive to incorporate is the ability to benefit from the small business deduction, and pay income tax at a combined federal and Ontario corporate rate of 19.12% as compared to the top combined marginal rate for individuals in 2002 of 46.41%.

⁵ An LLP limits professional liability to each partner's own actions and those employees or agents under his/her supervision.

⁶ All income tax rates used are based on a year-end of December 31, 2002.

For income earned in the company, personal tax will apply to any dividends paid out of corporate retained earnings. Consequently, the differential (46.41% versus 19.12%) in tax rates will only apply to the extent that the professional leaves the earnings in the corporation⁷. If the professional is spending most or all of the income that they make on an annual basis, the benefits⁸ of accessing the low corporate tax rate is minimal and would not, by itself, justify incorporation.

If the professional is not personally spending most or all of their income annually, the 19.12 % small business rate will provide the professional corporation with more “after tax dollars” with which to “finance” operations via repayment of existing corporate debt and/or purchase of capital assets. The corporation will also have more “after tax dollars” to finance non-deductible expenses, or those expenses for which the tax deduction is limited to 50%, such as meals and entertainment.

Due to the inability to earn income from other than the practice of the profession, “excess” cash and investments (i.e. assets not required to operate the business) most likely **cannot** accumulate inside the corporation. This rule will limit how much of the professional corporation’s earnings can remain in the corporation, to benefit from the small business deduction (“SBD”) tax deferral.

Please note that the small business rate of 19.12% is only available on the first \$200,000 of active business income⁹. To the extent that the taxable income of the corporation exceeds the Ontario small business limit,¹⁰ a claw back of the SBD may occur, eroding its tax deferral benefit.

A corporation must share the SBD with other associated corporations. If the goal is to maximize the SBD, it is important to ensure the professional corporation is not “associated” with another corporation. Association may occur where the professional holds at least 25% of the any class of shares in two corporations, each of which is

⁷ Funds withdrawn by a shareholder from a corporation (unless owing to the shareholder) must be taken in the form of income (either salary, dividends, or interest income on funds loaned to the corporation). Salary and interest will be deductible by the professional corporation and will be taxed in the hands of the individual. Dividends are taxed at a preferred rate in the individual’s hands, but no deduction is allowed to the corporate payor.

⁸ For 2002, the overall top tax rate (the combined corporate and personal tax rate of the individual and the corporation) on small business income paid out in dividends is 44.47%, a savings of almost 2% when compared to the top personal tax rate of 46.41%.

⁹ The corporate tax rate on the next \$80,000 of corporate income, i.e. from \$200,000 to \$280,000, is 28.12%, resulting in a tax deferral of 18.29%, (46.41% - 28.12%).

¹⁰ For 2002 the Ontario small business limit is \$280,000, and is scheduled to increase by \$40,000 per year to \$400,000 in 2005.

controlled by a related group of which he or she is a member. There are other situations where companies can be associated and thus share access to the SBD. As such, it would be prudent to have any corporate structure examined for association before implementation.

A sole proprietor will have access to the full amount of the SBD, but in a professional corporation with multiple shareholders, the benefit to each shareholder will decline. Specifically, where each individual has incorporated his/her own professional corporation, which is a member of a partnership, each corporation would only be entitled to a pro-rata share (based on its pro-rata share of income from the partnership) of the \$200,000 small business limit.

Capital Gains Exemption

Another attractive feature of incorporating is the potential to utilize the capital gains exemption to save income tax on the ultimate sale of the business/profession. The capital gains exemption is only available in respect of the disposals of qualified small business shares¹¹ and access to the exemption may be limited if the individual is subject to certain personal impediments. Whether or not the capital gains exemption can be accessed will depend on several factors, such as:

- whether a market exists for the shares (see below), and
- how much the share price would be discounted (as opposed to the sale of assets) for unknown corporate liabilities and to compensate the buyer for not obtaining an increase in the cost base of the underlying corporate assets purchased.

Should a shareholder own the shares on death, the capital gains exemption could be available to save income tax at that point, subject to the relevant criteria and potential restrictions.

Prospective purchasers of shares are limited. It appears that the buyer cannot be a corporation and must be a member of the profession. Thus, the buyer may not be able to set-up a holding company to buy shares, and may have to fund their purchase with after (personal) tax dollars.

Possible Income-Splitting

Unlike other provinces, Ontario **has not allowed** for income splitting with family members via shareholdings of a professional corporation, unless the family members are in the same profession. A management corporation or partnership owned by a spouse continues to be one alternative to split income. Another alternative would be

¹¹ A detailed discussion of the small business capital gains exemption, and potential restrictions is beyond the scope of this TaxTalk.

to pay reasonable salaries (based on the work performed) to family members involved in the business/profession.

Other Tax Issues

It is essential to consider all the tax implications of incorporating, including any potential income tax¹², goods and services tax, Ontario retail sales tax or land transfer tax that may be payable on the transfer of assets to a corporation.

Although business losses realized by a self-employed individual can be applied against other sources of income, the losses of a professional corporation are locked within the corporation and can only be carried back up to three years, and forward up to seven years against income of the corporation.

If one decides to incorporate, it will be necessary to determine the optimal time to incorporate, as well as the optimal year-end for the new corporation.

Other issues that may need to be addressed include:

- the possible inclusion of reserves (in the professional's income) on incorporation, such as the "1995 business income reserve",
- optimal salary/dividend mix to the owner managers,
- ensuring the shareholder understands the taxable benefit which results if corporate property is used personally, and
- ensuring the shareholder personally maintains separate accounts and records from the corporation.

Non-Tax Considerations

In addition to the tax issues, one must consider the initial legal and accounting costs of incorporating, as well as the ongoing legal, accounting and administrative costs of maintaining a corporation.

¹² Most transfers can occur on a tax deferred basis if a tax election form is filed on a timely basis.

When transferring the assets (and operations) of a practice to a professional corporation, many administrative matters must be dealt with, including the need to:

- obtain federal business numbers including income tax, GST, payroll and excise, as required
- obtain provincial business numbers, as required
- obtain new Workplace Safety and Insurance Board account, as required
- consider whether consent is required from bankers, landlord, equipment lessors, and major creditors
- notify insurers
- change 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, and
- in the case of a partnership, determine the methodology to administer "admission" and "departure" of shareholders. Will the new shareholder buy from treasury or from existing shareholders? Will shares of the vendor be purchased back by the corporation or purchased by the remaining shareholders? How will "retired" partners/shareholders be provided for, etc?

Summary

There are many advantages and disadvantages to incorporation of a professional practice. 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 company 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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