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INCORPORATION TAX BENEFITS FOR PROFESSIONALS

Bruce Ball / February 10, 2011

As a professional, significant tax planning opportunities can become available when you incorporate. These include splitting income with family members, taking advantage of low corporate tax rates to defer tax and possibly the capital gains exemption if you sell your corporation.

Before you decide to incorporate to take advantage of these opportunities, there are a number of important factors for you to consider. And in particular, unlike business people in general, you must consider the specific rules that govern your profession when determining whether incorporation makes sense for you.

The ability to split income with a spouse or an adult child is one of the main benefits of incorporation for business owners in general. As a professional, you will need to consider who is allowed to hold shares of the PC. Certain provinces will allow shareholders of the PC to include the professional along with their family members, while other provinces will allow only members of the profession to hold shares of the PC. Where family ownership is allowed, some provinces also restrict the use of trusts.

Where the rules allow, you can benefit from income splitting by allowing your spouse and adult children to subscribe for shares of the corporation and receive dividends from the profits of the PC. The advantage here is the ability to have the dividends taxed in the hands of more than one person, which generally means that the overall tax on the dividends within the family is lower. Note that due to the income-splitting tax (often referred to as the kiddie tax), the benefit of splitting dividend income with minor children is not available. It should also be noted that there are other rules that may reduce income splitting benefits, so professional advice is a must.

The second main benefit of incorporation is the ability to access corporate small business tax rates. Currently, a maximum of $500,000 of active business income qualifies for the federal small business rate (currently 11%). The provinces also provide low corporate tax rates on small business income that currently range from 1% to 8%.

Due to our integrated tax system, a substantial tax saving or cost generally does not arise in most provinces where small business income is earned through a corporation and paid out as a dividend to an individual who is taxed at the top rate. However, tax savings can be achieved where after-tax small business income is paid to a low income family member as a dividend (the income splitting advantage discussed above).

Another benefit can be achieved where business income is retained in the corporation, and the additional personal tax that will be payable when dividends are paid is deferred. The lower corporate tax rate leaves greater after-tax dollars in the corporation to pay expenses and reinvest in assets.

If you carry on business as a member of a partnership, the small business deduction rules will apply differently. Under the rules for partnerships that have corporations as partners, only one small business deduction will be effectively available to reduce corporate tax on income from the partnership. For example, if your PC earns 1/4 of the income from a professional partnership, only $125,000 of that income (1/4 of $500,000) will be eligible for the federal small business tax rates. However, certain structures can be used to effectively allow PCs of partners in professional partnerships access to a full small business deduction limit, but they require careful planning to implement and generally require that non-competition clauses in partnership agreements be eliminated.

The third significant tax advantage of incorporation that may be available is the capital gains exemption for qualifying small business corporation shares. Due to the nature of a PC as well as the restrictive ownership rules, selling shares and realizing a gain eligible for the exemption may be difficult. Purchasers may prefer to buy goodwill or client lists, rather than shares, and they may also have concerns about inheriting the professional liability of the vendor. A PC may also have significant passive assets.

To qualify for the exemption, the following general conditions must be met:

• At the time of the disposition, at least 90% of the corporation's assets (on the basis of fair market value) must be business assets;

• More than 50% of the corporation's assets (on the basis of fair market value) must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale;

• The shares must not have been owned by anyone other than the vendor or someone related to the vendor during the 24-month period immediately before the sale.

There are many factors to consider when deciding whether or not incorporation makes sense for you as a professional. The provincial rules for your profession need to be balanced with the tax rules to ensure you benefit from the tax planning opportunities available from incorporation, given the additional costs you may incur. And, professional tax advice is a must.

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