PROFESSIONAL CORPORATIONS

A summary of advantages and disadvantages

Kurt Rosentreter, CA

Now that dentists and other health care professionals are permitted to form professional corporations, many of you may be wondering if incorporating is the best route for you. To help you sort out your need for a professional corporation, I have created a summary of the main advantages and disadvantages. But this is not a comprehensive list. It is essential to take what you've learned and discuss your options with a qualified advisor.

ADVANTAGES OF PROFESSIONAL CORPORATIONS

- Professional corporations are subject to a reduced income tax rate on their first $200,000 of active business income. For 2002, the combined federal and provincial corporate tax rate is 19 per cent. Compare this to the top marginal tax rate of 46 per cent applicable to an individual with the same income and there is a significant deferral advantage to having income taxed within a company.

  In order to benefit from this deferral, you must be prepared to have significant amounts of your income left inside the corporate structure for years. This means that if you need all of your income to live your life, drawing all the income out of the corporation each year negates most or all of the tax advantages.
- The reduced tax rate on the first $200,000 of taxable income each year is known as the small business deduction, and it is applicable to the active business income of a qualifying small business. In the case of a professional corporation with many professional shareholders, they each have to share the $200,000.

  Each professional should want to create his or her own professional corporation to get the entire tax reduction on the first $200,000 of taxable income.
- Each year, a professional corporation can pay out compensation in the form of a salary, dividend or bonus. Since these different compensation types are often subject to different amounts of income tax, this can present tax planning opportunities, and the right mix of salary, dividend or bonus should be determined each year.
- It is not necessary for professional corporations to have a December 31 year-end for tax purposes. The corporation can set whatever year-end it chooses (July 31, for example). This presents a tax deferral opportunity for the shareholder if an off-calendar year-end is selected.
- One of the biggest advantages of having a professional corporation is the ability to utilize the $500,000 capital gains exemption with a sale of the corporation's shares on your retirement or death. The $500,000 exemption would apply provided a series of tests are passed, and would exempt the professional shareholder from tax on the first $500,000 of value when the shares are sold.

  As well, the capital gain on a sale of professional corporation shares would be taxed at much lower tax rates (23 per cent) than regular income. However, if a professional does not use a professional corporation and sells the assets of a practice instead, higher tax rates could apply (46 per cent).

  On death of a professional, it may be easier for surviving family members to sell shares of a practice than to sell off a variety of assets piece by piece — simply put, a sale of a practice on death can be "cleaner" if a corporation is used.

- Bonuses paid by a corporation can be deducted by the corporation in the current year. But payment of the bonus to the employee can be delayed for 179 days, creating income for the professional in the following tax year and generating a tax deferral. The effectiveness of this strategy is determined by the corporate year-end selected.
- Within a corporation, professionals can deduct the cost of attending more than two conventions each year for tax purposes. Normally, professionals without a corporation can only write off the cost of two business-related conventions in a year.
- Corporations can own their own group, sickness and income maintenance insurance policies, and their own life insurance policies. The advantage of this is that you can have the premiums paid out of pre-tax income instead of your personal after-tax income if you owned the policies personally.
- Having a professional corporation will allow you to set up a scholarship plan for your children.
- Within a corporation, an older professional can set up an Individual Pension Plan (IPP). An IPP is a defined benefit pension plan — the same kind of plan that government workers have — and under the right conditions it can allow a professional to accumulate more tax-deferred savings than are possible under an RRSP. It is a supplemental retirement savings plan that is well worth looking into.
- Within a corporation, a professional can also set up a retirement compensation arrangement (RCA). An RCA allows the corporation to fund a retirement capital pool for the beneficiary. Some time in the future you will draw the money out of the trust, hopefully at a time and in a tax jurisdiction that will result in reduced income tax.
- Within a corporation, a professional can set up an employee profit sharing plan (EPSP). An EPSP is another planning tool that allows the corporation to fund a savings plan on your behalf, but in this case, without having to make employer and employee contributions to the Canada Pension Plan for the professionals and their employee family members.
- Within a corporation, a professional can set up a health and welfare trust (HWT). A health and welfare trust is yet another planning tool that can be used to pay uninsured medical or dental expenses of professionals and their families. The payments would be fully tax deductible to the corporation.
- A corporation offers some creditor-proofing advantages for professionals worried about being sued. A corporation could serve as a mechanism to block some creditors from reaching your personal net worth. A professional corporation offers limited liability against leases, non-guaranteed bank loans, trade accounts payable and non-professional contingencies.

A professional corporation does not, however, offer protection of your assets against malpractice. In this case, you will need to purchase malpractice insurance to guard against this kind of possible threat. It may be possible, though, that corporate funds loaned to, or invested in, another corporation owned by a spouse, can provide the desired creditor proofing protection against malpractice as well.

- Using a professional corporation allows you to pay an appropriate salary to family members employed in your practice. It would be desirable to pay up to $75,000 of salary in order to maximize the RRSP contribution room of $13,500 each year, but the income must be justifiable. As well, family members earning salaries have income that qualifies for the Canada Pension Plan. Generally, it is wise to plan to involve a spouse and children in your corporation, even in some minor way.

- It may be more desirable for a professional corporation to purchase a building in which you want to work, instead of purchasing it yourself as an individual. This way, the corporation can apply income taxed at a low rate against mortgage payments, accelerating the mortgage repayment.
- Having a professional corporation may result in better bookkeeping. With a corporation, you need separate letterhead, distinctive business cards, corporate financial statements, a corporate bank account and credit card, and you need to file a corporate tax return each year. If you currently have the bad habit of mixing business and personal financial records, having a corporation will force you to keep better records.
- With a corporation in place, in some circumstances it may be possible to convert non-tax-deductible debt you have into tax-deductible debt. This would allow you to write off interest expense annually against your taxable income.
- With a professional corporation there would be no tax instalments to make in the first year. This provides a tax deferral.
- Finally, it is possible for you to set up a second "tandem" corporation that is owned by a spouse. In some professions, this second corporation can provide management services to the professional services corporation. The advantage of a management company is the fact that the spouse, as a shareholder, can benefit from his or her own $500,000 capital gains exemption.

Due to new tax rules, dividends paid to minors or a trust that benefits minors are now taxed at the highest tax marginal rate. This requires careful consideration when planning how to split income with children.

Disadvantages Of Professional Corporations

While it may seem as if there are many advantages of a professional corporation, there are a few important disadvantages that will make a professional corporation less relevant to your situation.

- Foremost, the tax benefits associated with a professional corporation will only work if you can leave significant amounts of money within the corporation — this means you shouldn't use all of your earnings personally each year. If you are in the habit of spending all of your income, a professional corporation is likely not for you.

- If you are in a practice or firm with several other professionals, setting up a joint professional corporation may dilute some of the tax advantages. This makes professional corporations most beneficial to the sole practitioner.
- Professional corporations cannot limit liability for malpractice. You will need to explore other ways to protect yourself in this case.
- With a corporation, you will have mandatory tax with holdings and instalment payments. This forces a level of discipline to which you may not be accustomed.
- With a corporation, you will need to beware of taking cash advances, as they can cause unwanted tax liabilities in the form of imputed interest charges and income inclusions if not planned properly.
- As much as a professional should want to sell shares of a corporation when he or she retires (to benefit from the $500,000 tax exemption), you have to ask whether another professional will want to buy shares. When you buy shares of a company, you get the whole company — good and bad. Buyers may prefer to buy assets and client lists only — allowing them to cherry-pick the best assets and only buy those. No one wants to buy someone else's "baggage." This may make it hard to sell a professional corporation and realize the tax breaks.
- Setting up and maintaining a professional corporation will result in annual tax, accounting and legal costs. These fees will range from $1,500 to $10,000 annually depending on the complexity of what you are doing.
- Shares of professional corporations can only be owned by professionals — no non-professional family members allowed. This really puts a damper on tax planning and income splitting with family members. You can't even use a personal holding company to own shares in the professional corporation — a technique often used to move money in an inter-corporate fashion for tax advantages.
- Director's fees are not allowed in a professional corporation. Therefore, you can't pay director's fees to a spouse, for example, and split income for tax advantages.
- There are two different kinds of income tax breaks offered by a professional corporation: tax deferral that results from leaving money in the corporation, and an outright tax savings when you factor in the corporate and personal taxation that will be paid before the money gets to your hands personally. While there is a significant deferral advantage (27 per cent) by leaving money in the corporation, the absolute tax savings are currently less than two per cent in Ontario. It would be wise to calculate these benefits using tax rates applicable to you, and compare them against the costs of a professional corporation.
- Professionals with existing corporations that they use for other purposes (investment portfolio, real estate, technical services corporation) will want to avoid the "association" rules in the *Income Tax Act* if they set up a professional corporation. If two corporations are found to be associated, they will have to share the tax reduction benefits for income below $200,000 per year. This is generally not desirable.
- Partners in partnerships that convert to a professional corporation will lose the benefit of the income reserve that they may currently be claiming. The 10-year reserve rule was enacted in the 1990s when partnerships were required to move to calendar year-ends. Partners of qualifying partnerships are generally still several years away from winding up their reserves. Moving to a professional corporation structure would see the reserves taken into income now, losing the tax deferral.
- With a professional corporation it would not be possible to split income for tax purposes with family using dividends. Dividends are among the lowest taxed forms of investment returns in the hands of Canadians.
- Any investment income earned inside the professional corporation is taxed at full tax rates, however, there is a refundable tax mechanism that effectively reduces the tax rate when dividends are paid to the shareholders.
- Professionals that decide to take shareholder loans from their corporation need to understand the complex rules around taxation of shareholder loans. Planning your income needs when a corporation is in place needs to be well thought out in advance.
- It would not be wise to have the corporation purchase personal assets. Instead, personal assets should be bought in your hands and the corporation should reimburse you for any business usage of your personal asset. The best example is a vehicle. It is generally not wise to buy an expensive vehicle through the company, as you will be subject to taxable benefits and limited writeoffs.

Conclusion

Reading this article is just the beginning. The above list is just an overview to get you thinking about your options. Your next step should be to sit down with a professional advisor who is familiar with the rules of professional corporations, to review the applicability of the rules to your personal situation. ◆

This article does not include proposed changes to the Income Tax Act *as a result of the 2003 Federal Budget, which may have an impact on some of the tax implications mentioned.*

Kurt Rosentreter is a Senior Financial Advisor at Berkshire Securities Inc. in Toronto, and a Chartered Accountant specializing in advanced financial strategies for medical professionals. He can be reached at 416-988-8900 or krosentreter@berkshire.ca.