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FINANCIAL ADVISORY SUPPORT

Professional Corporations

This article discusses the advantages and potential drawbacks of professional corporations.

What is a professional corporation?

A professional corporation is a corporation owned and operated by one or more members of the same profession (e.g. physicians, lawyers, accountants, dentists). The services provided by the corporation are generally restricted to the practice of the profession.
Professional corporations are now allowed in every province and territory across Canada. In each province/territory, the professional regulatory body usually determines whether its members may incorporate. For example, the regulatory body for physicians, in all provinces and territories, allows physicians to incorporate.

How does it differ from a common corporation?

There are some significant differences between a professional corporation and a common corporation such as:

- Only members of the same profession can be shareholders of a professional corporation in many (but not all) provinces.
- The officers and directors of a professional corporation must generally be shareholders of the corporation as well.
- The professional corporation is generally subject to the investigative and regulatory powers of the regulatory body governing the profession.
- A professional corporation will not protect a professional against personal liability for professional negligence.

As a result of these differences, some of the benefits commonly associated with a corporation may have a limited application for a professional corporation. This is further described below.

Advantages of using a professional corporation

Potential tax savings

A reduced federal and provincial corporate tax rate is applied on the first $400,000 of professional income earned by a professional corporation. Some provinces apply the reduced tax rate on income of up to $500,000. The provincial limit varies by province. For 2010, the combined federal and provincial tax on income subject to the small business limit will range between approximately 11% and 19%. As a result of this lower rate, the combined corporate and shareholder taxes paid on professional services income is slightly lower than if such income were to be earned by you directly.

Potential tax deferral

Perhaps the most significant advantage of using a professional corporation is the ability to defer taxes. Professional income earned through a corporation is taxed at two levels — once at the corporate level and then again at the shareholder level when the profits are distributed to you as dividend income.

Since income at the corporate level is taxed at a lower rate than your personal income, a tax deferral opportunity exists when the income is taxed in the corporation (at the lower rate) and is not distributed to the shareholder (i.e. you). The deferral ceases when a dividend is paid to you and you pay the tax on that dividend.

Let’s illustrate. If you earn a professional income of $500,000 per year as a sole proprietor and only need $300,000 of pre-tax income for personal expenses, you will be left with $200,000 that will be taxed at the highest marginal rate. Assuming a marginal tax rate of 47%, you will be left with $106,000 to invest.

On the other hand, if you incorporate the practice, the $200,000 will be left in the corporation and taxed at the small business rate. Assuming a corporate tax rate of 18%, the corporation will be left with $164,000 to invest. That’s $58,000 more.

	Sole proprietor	Professional corporation
Income	$500,000	$500,000
Personal needs	($300,000)	($300,000)
Remaining funds	$200,000	$200,000
Taxes	($94,000)	($36,000)
Net funds	$106,000	$164,000
Additional funds in the professional corporation	**$58,000**	

The additional funds in the corporation may be used to pay off debt, purchase capital assets, acquire investments or fund an insurance policy

Flexible employee benefits

As an employee of a professional corporation, you can access certain types of employee benefits that would otherwise not be available if you were a sole proprietor or a partner in a partnership.

For example, the corporation can establish an Individual Pension Plan (discussed later on) or a Retirement Compensation Arrangement (RCA) for you. These retirement savings vehicles can also provide you with possible creditor-protection benefits. An employee health and welfare trust can also be created to provide health benefits for you and your family.

Capital gains exemption

The Canadian tax rules permit that up to $750,000 in capital gains arising from the sale of the shares of a qualified small business corporation may be exempt from tax. This $750,000 capital gains exemption is also available for shares of a professional corporation, provided certain conditions are met. However, the ownership of a professional corporation may not be as easily transferable since, in many provinces, it can only be transferred to members of the same profession.

Flexibility in remuneration

You can choose to receive a combination of salary and dividends from a professional corporation. The decision is based on the combined corporate and shareholder taxes paid in your province of residence.

Limited commercial liability

A professional corporation does not generally protect you from personal liability for professional negligence. However shareholders of a professional corporation will have the same protection as other corporate shareholders when it comes to trade creditors.

Income splitting

You can split income through a corporation by paying dividends to adult family members who are shareholders of the corporation. This strategy may be less applicable to professional corporations situated in provinces where share ownership is restricted to members of a particular profession. However other income splitting strategies, such as hiring family members to work in the business and paying them a reasonable wage for services rendered, are still available through a professional corporation.

Multiple small business deductions

As a result of a Canada Revenue Agency (CRA) ruling, it is possible for professionals operating through a professional partnership to render their services through a professional corporation and be able to access multiple Small Business Deductions (SBDs).

Income earned up to the SBD limit of $400,000 is subject to a preferential tax rate (some provinces have a higher SBD). Historically, the SBD had to be shared among all corporate partners. Given CRA's new ruling, professionals currently operating as a partnership should consider the benefits of setting up a professional corporation to take advantage of multiple SBDs.

Individual pension plan

An Individual Pension Plan (IPP) is a defined benefit pension plan that a professional corporation can set up for the professional. The IPP provides better annual contributions than RSP limits for those over 40. Assets in an IPP are protected from creditors; however, they may be subject to locking-in provisions during retirement. If you would like more information on IPPs, please consult your advisor.

Disadvantages of a professional corporation

Costs and complexity

The costs for establishing and maintaining a professional corporation are usually higher than those of a sole proprietorship. Also, a professional corporation will incur more costs to file a corporate tax return, prepare T4 slips for salaries and T5 slips for dividends. A corporation is also subject to greater regulation and compliance than a sole proprietorship or partnership.

Employer health tax and EI premiums

Corporations in several provinces have to pay a provincial health tax levy once the corporate payroll has exceeded a certain threshold. Fortunately the basic amount you are not taxed on is fairly high (e.g. $400,000 in Ontario) so the impact of this tax on professional corporations may not be that significant.

Business losses

You cannot claim business losses incurred by a professional corporation on your personal tax return; whereas, in a sole proprietorship, you may use the business losses to offset your personal income from other sources.

Liability for malpractice

As mentioned above, a professional corporation will not protect you from personal liability for professional negligence.

Who should use a professional corporation?

A professional corporation can provide potential tax savings and tax deferral benefits. This may appeal to you if you do not require all of your income to live on. Professional corporations may also appeal to you if you wish to save for your retirement through alternative means, such as a pension plan or retirement compensation arrangement, or if you would like to limit your personal exposure to commercial liability.

If you have questions on any of the issues discussed in this article, please speak with your advisor.