The Navigator

RBC WEALTH MANAGEMENT SERVICES

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Is incorporating your professional practice right for you?

Over the past decade, every Canadian province and territory has enacted legislation that allows professionals to obtain the same tax advantages as other small business owners. These tax-related advantages stem from the ability to incorporate and the ability for family members to own shares. When considering incorporating your professional practice, there are a number of benefits, primarily tax advantages, to think about. At the same time, there are disadvantages of which you should also be aware.

What is a professional corporation?

A professional corporation is a corporation owned and operated by one or more members of the same profession, such as physicians, lawyers, accountants or 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, 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 it works

In many, but not all, provinces and territories, only members of the same profession can be voting shareholders. Each profession, by province, has specific rules as to who can hold the shares of a professional corporation. For example, these rules could state whether the shares can be held by a holding company, family members or a family trust. The officers and directors of a professional corporation must generally also be shareholders of the corporation and the professional corporation is usually subject to the investigative and regulatory powers of its regulatory body.Lastly, note that a professional corporation will not protect a professional against personal liability for professional negligence.

Tax advantages

There are several tax advantages available to professional corporations that are not available to professionals who work as sole proprietors. These include the opportunity to defer taxation by leaving money in the corporation and the tax savings that can result from the lower corporate tax rate, the ability to draw dividend income from a corporation and the opportunity to income split after-tax corporate earnings by paying dividends to adult family members who are shareholders of the professional corporation.

It is important to understand that there are also drawbacks to operating a professional practice in a corporation.

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 as dividend income. Since income at the corporate level is taxed at a lower rate than 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. However, 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 (including taxes), you will be left with $200,000 that will be taxed at the highest marginal rate. Assuming a marginal tax rate of 47 per cent, you will be left with $106,000 to invest.

	Sole proprietor	Professional corporation
Income	$500,000	$500,000
Personal needs (including taxes)	($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	

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 per cent, the corporation will be left with $164,000 to invest. That's $58,000 more that could be used to pay off debt, purchase capital assets, acquire investments or fund an insurance policy, among other things.

The most significant advantage to a professional corporation is clearly the potential tax savings and deferrals, which can be very appealing if you do not require all your income to live on.

Potential tax savings – combined corporate and personal taxes

Another advantage is tax savings. A reduced federal and provincial corporate tax rate applies to the first $500,000 of active business income earned by a professional corporation. Manitoba and Nova Scotia apply the reduced provincial tax rate on the first $400,000 of active business income. For 2012, the combined federal and provincial tax on income subject to the small business rate ranges between approximately 11 per cent and 19 per cent. As a result of this lower rate, the combined corporate and individual taxes paid on the first $500,000 of professional services income earned through a corporation is generally lower than if you earned this income personally. Prince Edward Island and Quebec are exceptions to this rule.

For example, if a doctor in Ontario asked his advisor to quantify the potential tax benefits of a professional corporation using RBC's 2012 Professional Corporations Decision Tool, he would get the following calculation:

If the doctor earned $500,000 in 2012 as a sole proprietor (with no other income), he would be left with $288,421 of after-tax income in 2012. Through a professional corporation, the same $500,000 would result in net after-tax corporate income of $420,810 (assuming the only incremental cost is $2,000 annual compliance cost). If the corporation distributed the 2012 after-tax corporate income as dividend income in 2012 and incurred tax at the shareholder level, the doctor's after-tax income would be $304,220, resulting in tax savings of $15,799.

Potential tax savings – income splitting

You may be able to 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, for example, lawyers and accountants in Ontario. However, other income-splitting strategies, such as hiring family members to work in the business and paying them a reasonable salary for services rendered, are still available through a professional corporation. Paying your family members a reasonable salary for the services they provide could also provide them with RRSP contribution room and enable them to make CPP contributions.

In our example on page 20, the tax saving available through the use of a corporation was $15,799 where the professional is the only shareholder of the corporation. Using the same tool, the advisor was also able to quantify the following:

If a spouse is added as a shareholder and after-tax corporate income is paid out as dividends and split 50/50 with the spouse ($210,405 each) then the total after-tax income for both is $324,688 resulting in a tax savings of $36,267 compared to earning professional income as a sole proprietor. Similarly, if two adult children are added as shareholders and the corporate after-tax income is split four ways ($105,202 each) then the total after-tax income for all four is $365,124. The resulting benefit is $76,703 compared to earning professional income as a sole proprietor.

The following table summarizes the above scenarios

After-Tax Income Summary						
	Total tax savings*	Total after-tax income	Client	Spouse	Adult child #1	Adult child #2
Scenario #1 – Sole Proprietor		$288,421	$288,421			
Scenario #2A – Professional Corporation	$15,799	$304,220	$304,220			
Scenario #2B – Professional Corporation – 2 shareholders	$36,267	$324,688	$162,344	$162,344		
Scenario #2C – Professional Corporation – 4 shareholders	$76,703	$365,124	$91,281	$91,281	$91,281	$91,281

* Total tax savings compared to earning professional income as a sole proprietor under Scenario #1

The chart illustrates the potential annual tax benefit of splitting professional income through a corporation by paying dividends to adult family members who are shareholders of the professional corporation (where permitted). Keep in mind that for this to work, the recipients must be in lower tax brackets. The above examples also illustrate the maximum tax savings available as it assumes the recipients have no additional sources of income other than the dividend income from the professional corporation.

Potential tax savings – capital gains exemption

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 (QSBC) may be exempt from tax. If a professional corporation qualifies as a QSBC, this $750,000 capital gains exemption is also available upon the sale of the shares. Therefore, incorporating your practice enables you to sell your interest in the practice as shares, which means up to $750,000 of tax-free capital gains. In fact, for members of certain professions, for example, the medical profession in all provinces and territories, it may be possible to access more than $750,000 in tax-free capital gains by having other family members own shares of a professional corporation. 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.

Other advantages

Although the primary benefits of incorporating a professional practice are the tax advantages that are available, other benefits of incorporation include:

- **Flexible employee benefits** – access to certain types of employee benefits that would otherwise not be available if you were a sole proprietor or a partner in a partnership, such as membership in an Individual Pension Plan (IPP) and Retirement Compensation Arrangement (RCA).
- **Flexibility in remuneration** – the option to receive a combination of salary, bonus and dividends from a professional corporation.
- **Limited commercial liability** – the same protection as other corporate shareholders when it comes to trade creditors.

Disadvantages of a professional corporation

It is important to understand that there are also drawbacks to operating a professional practice in a corporation. These include:

- **Costs and complexity** – costs for establishing and maintaining a professional corporation are usually higher than those of a sole proprietorship.
- **Employer health tax and Employment Insurance (EI) premiums** – corporations in several provinces have to pay a provincial health tax levy once the corporate payroll has exceeded a certain threshold.
- **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.
- **Personal use of corporate funds** – by incorporating your professional practice, you cannot use corporate funds for personal expenses unless you first get the money out of the corporation using a legitimate method such as paying salaries, bonuses or dividends.
- **Association** – be aware of association rules if you have other family members who have corporations that qualify for the small business deduction (SBD). This can cause problems if you have ownership in

their corporation or they have ownership in your corporation. In this context ownership refers to direct ownership or indirect ownership, for example, through a trust. If corporations are associated, they have to share the SBD, which may not be desirable.

- **Liability for malpractice** – a professional corporation will not protect you from personal liability for professional negligence.
- **Period of existence** – a professional corporation may have a much shorter existence than a regular corporation since the voting shares generally have to be owned by individuals who are members of the same profession and the corporation may not carry on business other than the practice of the profession.

Weigh the pros and cons

The most significant advantage to a professional corporation is clearly the potential tax savings and deferrals, which can be very appealing if you do not require all your income to live on. They can also be advantageous if you wish to save for your retirement through alternative vehicles such as an IPP or RCA, or if you want to limit your personal exposure to commercial liability. Consider the advantages and disadvantages of incorporation carefully and consult a tax advisor if you are considering setting up a professional corporation.

The following article appeared in the special Business Owner's edition of RBC Perspectives Magazine.

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