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FINANCIAL ADVISORY SUPPORT

Professional Corporations

This article discusses the advantages and disadvantages of professional corporations. You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been properly considered and that action is taken based on the most current information available.

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 etc.). 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 regular corporation?

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

- Only members of the same profession can be voting shareholders of a professional corporation in many (but not all) provinces. Each profession in each province has specific rules as to who can hold the shares of a professional corporation (e.g., whether shares can be held by a holding company, family members or a family trust).
- 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 $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% and 19%. 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 such income were earned by you personally (Nova Scotia, Prince Edward Island and Quebec are the exceptions).

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, among other things.

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. If you would like more information about RCAs please consult your advisor.

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 (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. 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, bonus and dividends from a professional corporation. In addition to other factors, this decision is based on the combined corporate and individual taxes paid in your province of residence. You may also be able to defer the payment of tax on bonuses since the professional corporation can deduct bonuses accrued at year end but paid in the following year within 179 days. However you would not have to include the bonus in income personally until they are received.

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 salary for services rendered, are still available through a professional corporation. Further, paying your family members a reasonable salary could also provide them with RRSP contribution room and CPP contributions.

Multiple small business deductions

According to Canada Revenue Agency (CRA) rulings, it is possible for professionals operating through a partnership to render their services to the partnership through a professional corporation and for each professional corporation to be eligible for their own small business deduction (SBD) as long as certain conditions are met. Generally, corporate partners must share the SBD, however if the following conditions are met then each professional corporation will be allowed their own $500,000 SBD (Manitoba's and Nova Scotia's SBD is $400,000):

- A partnership agreement must not exist between the professional corporations (if a partnership agreement exists between the professional corporations, the professional corporations' income would be considered "specified partnership income" which would mean that all the corporate partners would have to share the SBD with respect to the partnership income)

- A partner providing services to the partnership through a professional corporation should not be considered an officer or employee of the partnership in respect of those services if the corporation was ignored. This is determined based on the facts in each situation. If this condition is met, then the professional corporation will not be considered to be carrying on a personal service business (PSB). A PSB would not be eligible to claim the SBD.

This arrangement will only work if all the conditions are met and the business is properly structured.

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 contribution limits than an RRSP for those over age 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 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. 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.

Personal use of corporate funds

If you incorporate 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, bonus or dividends. Using corporate funds for personal expenses can cause tax liabilities such as imputed interest benefits or income inclusions. Besides the methods mentioned above, there are other ways to get cash out of a corporation. If you would like more information on this please speak to your advisor.

Association

You should be aware of the association rules if you have other family members with corporations that qualify for the SBD where you have ownership in their corporation or they have ownership in your corporation (ownership refers to direct ownership or indirect ownership such as through a trust). If corporations are associated, they have to share the SBD which may not be desirable.

Liability for malpractice

As mentioned above, 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 of the same profession and the corporation may not carry on a business other than the practice of the profession. This does not mean that the corporation would have to be wound up. When the professional dies or no longer practices, (assuming there are no other professional shareholders) the corporation would lose its status as a professional corporation unless the shares can be transferred to another individual of the same profession.

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 an IPP or RCA, 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.