RBC Wealth Management Services

The Navigator

Wealth Planning for Health-Care Professionals – Part 2: Starting Out on Your Own

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Whether you are a new graduate, working as an associate, running your own practice or approaching retirement, tax, financial and retirement planning will always play a key part at every stage of your career. As your personal, professional and financial situations evolve, you should ensure that you've done appropriate planning to help you achieve your goals and objectives throughout the different stages of your professional life.

The content in this article is for information purposes only and does not constitute tax or legal advice. It is imperative that you obtain professional advice from qualified tax and legal advisors before acting on any of the information in this article. This will ensure that your own circumstances are properly considered and that action is taken based on the most current legislation.

This four-part series takes you through some of the key planning issues you should consider at various stages of your professional career.

Part 1: The Early Years

Part 2: Starting Out on Your Own

Part 3: The Peak Earning Years

Part 4: Preparing for Retirement

Part 2 of this four-part series addresses the relevant issues you may face when you have practiced as an associate for a few years, observed different practice options and are ready to own your own medical or dental practice.

The practice arrangement you choose should be compatible with your personality, personal goals, preferences and financial constraints.

Practice Options

You have been working as an associate for a few years and have gained some experience in your field of expertise. Now you are ready to consider being a practice owner. Do you have the option of buying into the existing practice you are working in and becoming a partner in that practice? Do you want to start practicing on your own either by creating a practice from scratch or buying an existing practice? The practice arrangement you choose should be compatible with your personality, personal goals, preferences and financial constraints.

Partaking in the ownership of a practice means that in addition to your normal duties, you will also have to become involved with the business and administrative side of running a practice. You will need to become familiar with financial planning, ways to raise capital, office management, and more. You may also deal with issues such as, hiring of staff, billing arrangements, regulatory requirements, structuring your practice (which may involve the use of a corporation(s) or partnership), cost-sharing and shareholder arrangements.

Buying into a Practice or Partnership

Perhaps the existing physician or dentist you are working with hired you because they are retiring and have been grooming you to succeed their practice, or perhaps you want to join a group of physicians or dentists with an existing practice who are looking to expand. In either case, depending on the sale agreement and the organizational structure of the practice, you will either become a partner by buying an interest in the partnership or you will become a shareholder by acquiring shares of the professional corporation.

Starting Your Own Practice

If you have gained sufficient experience in your medical or dental field and observed different practice styles from your years as an associate, you may be ready to start your own practice. The benefit of creating your own practice is that you are in control of the practice philosophy and the scope of the practice. However, you may face some challenges, both financially and administratively, in making this transition including identifying a desirable location to set up your practice, securing financial support (obtaining loans), leasing space, hiring staff, purchasing or leasing equipment, purchasing inventory and supplies, furnishing your office, obtaining computers and business software systems, opening accounts with vendors, and building a patient base.

Purchasing a Practice

If you want control of your own practice but do not want the burdens of a start-up, you may consider purchasing an existing practice. Some of the main advantages of purchasing an existing practice are that you can anticipate the income and operating expenses of the existing practice; there is an active patient base which means that you can expect to earn income immediately; and, the staff are already familiar with the practice's operating systems so you do not have to hire and train new employees. The disadvantages, however, of purchasing a practice include higher financing costs, unknown staff or patient conflicts, potentially out-dated equipment, and an indeterminate loss of existing patients due to the transition.

Different Business Structures

As an unincorporated individual, you can structure your practice either as a

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sole proprietor (owning your practice assets directly) or as an individual partner with a participating interest in a partnership. Alternatively, you can form a corporation and operate your practice through the corporation. The setup of a sole proprietorship and the formation of a partnership are relatively simple and inexpensive, whereas corporations are more costly to create and maintain. You should note that if you decide to operate your practice as a sole proprietor or if you are a partner of a partnership, you have the option of transferring your practice or partnership interest to a corporation at a later date, potentially on a tax-deferred basis.

The practice may be structured and operated in one of three ways, the features of which are summarized in the following table.

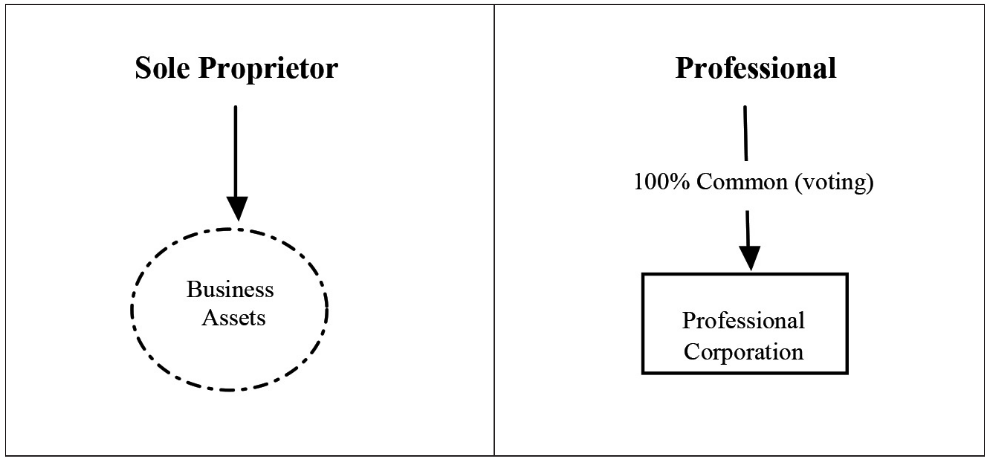
Features of Different Business Structures

	Sole Proprietorship	Partnership	Professional Corporation (PC)
Legal entity	No distinctions drawn between the owner and the proprietorship.	A business relationship between two or more persons. It is not a separate entity.	A corporation is a legal entity, distinct from its shareholders.
Legal feature	No one particular body of law governs this type of structure.	The three criteria essential to the existence of a partnership are: 1) the existence of a business, 2) carried on in common by the partners, 3) with a view to profit.	A PC is a legal entity which must be incorporated under the appropriate provincial legislation.
Level of control	Direct personal control.	Shared with partner(s).	Direct personal control if sole shareholder or shared with other professional shareholders.
Legal liability	The individual is personally liable for the debts of his/her sole practice.	Joint and unlimited liability among the partners for the debts of a general partnership. This liability extends to the personal assets of each partner. Partner in limited liability partnership is generally not liable for acts and omissions of other partner.	Shareholders enjoy limited liability protection but the professional is jointly and severally liable with the PC for all professional liability claims made against the PC.
Licensing	The individual must be licensed by the relevant professional governing body such as the College of Physicians and Surgeons or the College of Dental Surgeons in the province in which he/she operates.	Each professional working on behalf of the partnership must be licensed.	The PC must be certified by the relevant professional governing body (i.e., obtain a "Certificate of Authorization" or license/permit).
Tax year	Income is reported on a calendar year basis (i.e., December 31 year-end).	Partnerships with at least one member who is an individual or a PC must have a December 31 year-end.	The PC has its own fiscal year which may differ from the calendar year. A PC which is a corporate partner of a partnership must have a December 31 year-end.
Taxation	Taxed personally.	Partner's share of profit is taxed personally.	Salary paid by the PC to the individual is taxed personally. The PC's taxable income (after deducting salary expense) is taxed at the corporate level at corporate rates. The PC's after-tax income can be distributed to the individual as a taxable dividend.

Which Practice Option is Right for You?

The following figures illustrate possible business structures that you may wish to consider when setting up your practice.

A. Sole Proprietorship vs. Professional Corporation



If you are operating as a sole proprietor, the taxable income you earn (i.e., revenues less tax deductible expenses) is considered professional income and taxed in your hands in the year it is earned.

When you start your practice from scratch, you can become a sole proprietor or a shareholder of your own professional corporation (PC). If you are operating as a sole proprietor, the taxable income you earn (i.e., revenues less tax deductible expenses) is considered professional income and taxed in your hands in the year it is earned. If you operate your practice through a PC, the taxable income earned is taxed in the corporation. You may wish to draw a salary from the corporation or receive a dividend distribution from the corporation as remuneration, both of which would be taxable to you personally in the year it is received. If you require all the funds from your practice for personal spending, from a tax perspective, you should be indifferent to running your practice as a sole proprietorship or through a corporation.

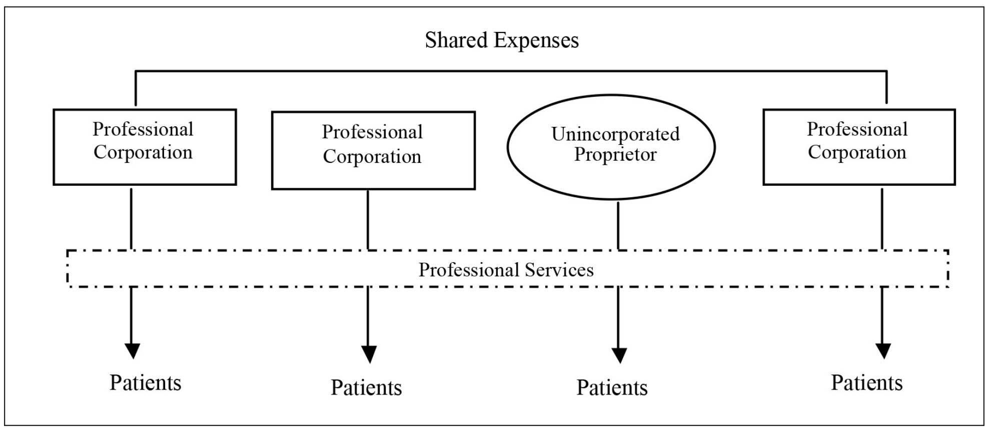
The above diagrams also illustrate the possible structures available if you were to purchase an existing practice. Where the existing practice is set up as a corporation, the transaction can be structured as an asset sale or a share sale. If the vendor is selling you the assets of the professional practice, you can either make the purchase as an individual or you can first incorporate your own PC and then buy the assets. If the vendor is selling the shares of a PC, you can either purchase the shares and become the sole shareholder, or if you already have your own PC, you may wish to have the corporation buy the shares from the vendor and subsequently merge the two PCs together to form one corporate entity.

If you earn professional income as an unincorporated sole proprietor, the taxable income is taxed at your individual marginal tax rate. If the professional income is earned in your PC, the taxable income would be considered active business income for tax purposes. Active business income is subject to the general corporate tax rate, at both the federal and provincial levels. If the taxable income earned is below the business limit (discussed below), there is a deduction that reduces the tax rate at the corporate level, known as the small business deduction. The business limit at the federal level is $500,000

Under a cost sharing arrangement, the professionals earn their own revenues, but split costs for things such as facilities, staff, and other common costs

and the provincial business limit is $500,000 (except for Manitoba and Nova Scotia where the limit is $400,000). The amount of taxable income on which a corporation can claim the small business deduction is capped at the corporation's business limit. The business limit must be allocated between corporations that are associated with each other in a taxation year. (The association rules are discussed in part 3 of this four-part series.)

B. Cost Sharing Arrangement between Sole Practitioners



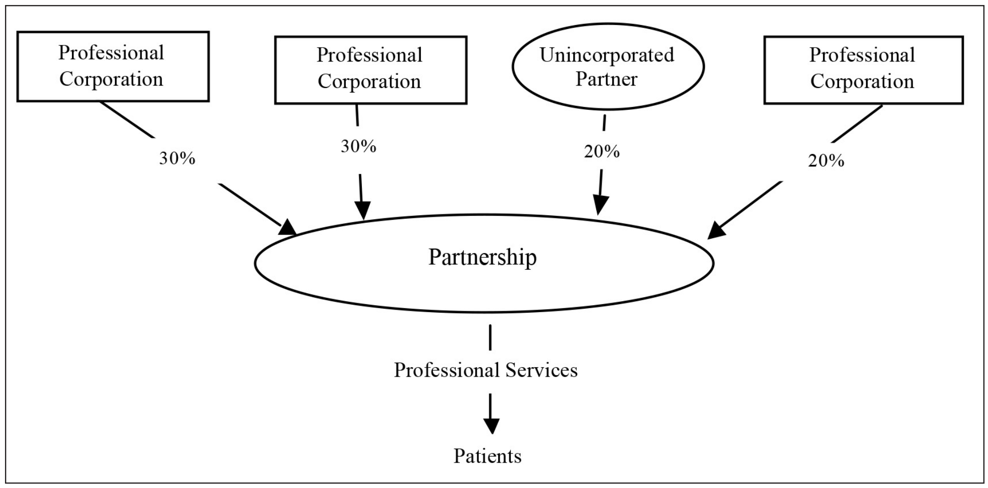
Cost sharing arrangements are very common in the dental and medical professions due to commercial and tax advantages. Under a cost sharing arrangement, the professionals earn their own revenues, but split costs for things such as facilities, staff, and other common costs. This arrangement allows the group of professionals to share the administrative and office costs as well as certain capital expenses, such as major equipment or office renovations. This arrangement also provides the professionals with most of the advantages of an individual practice, while benefiting from economies of scale resulting in less overhead per practitioner. These cost sharing arrangements are distinct from partnerships as they do not possess the three required elements of a partnership established by the courts. The elements of a partnership are: 1) the existence of a business, 2) carried on in common by the partners, 3) with a view to profit. In most cost sharing arrangements, the business is not carried on in "common". Each professional carries on their own activities for their own benefit. There is no splitting of profits but only a sharing of costs.

Under this structure, each professional controls their own PC and in the case of the unincorporated proprietor, the professional acts as a self-employed individual.

Each incorporated proprietor or PC is entitled to a small business deduction on their own taxable income. Depending on the province, each PC that earns net professional income below the business limit is subject to tax at a low rate of 11% – 19% on that professional income.

It is very important that a cost sharing arrangement is not viewed as a partnership. Otherwise, you will have to share the small business deduction benefits amongst the partners. This could significantly reduce the tax benefits of incorporating.

C. Partnership - Unincorporated Proprietor vs. Incorporated Partner



Under this structure, you can be an unincorporated partner or you can form your own PC and have it be a corporate partner of the partnership. Because partnerships do not pay tax, the partnership's income will flow through to the partners who will then report their share of the partnership's taxable income on their respective income tax returns. If you are an unincorporated partner, your share of the partnership income is reported on your personal income tax return as partnership income and taxed at your marginal tax rate. If your PC is a corporate partner, it will report its pro rata share of the professional income on its corporate tax return. As the professional, you can either draw a salary from the PC or receive a distribution from the PC in the form of a dividend, both of which are taxable in your hands in the year of receipt.

There are "specified partnership income" rules in the Income Tax Act that are designed to prevent the multiplication of the small business deduction where an active business is carried on as a partnership with corporate partners. The result of the application of these rules is that a group of corporate partners must share one small business deduction in respect of the partnership income. For example, if the partnership has net professional income of $1,200,000 and your PC's share of the income is 25% ($300,000), then only $125,000 will qualify for the small business deduction federally and $125,000 will qualify provincially ($100,000 if in Manitoba or Nova Scotia), calculated as your 25% share of the small business limit. The remaining allocated partnership income will be taxed at the general corporate tax rate of between 25% - 31% depending on the province of residence. The PC is still entitled to the full business limit, so additional active professional

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income of up to $375,000 federally and $375,000 provincially ($300,000 if in Manitoba or Nova Scotia) could be earned by the PC from other sources and could still qualify for the small business rate.

D. Group Practices – Newer Structures

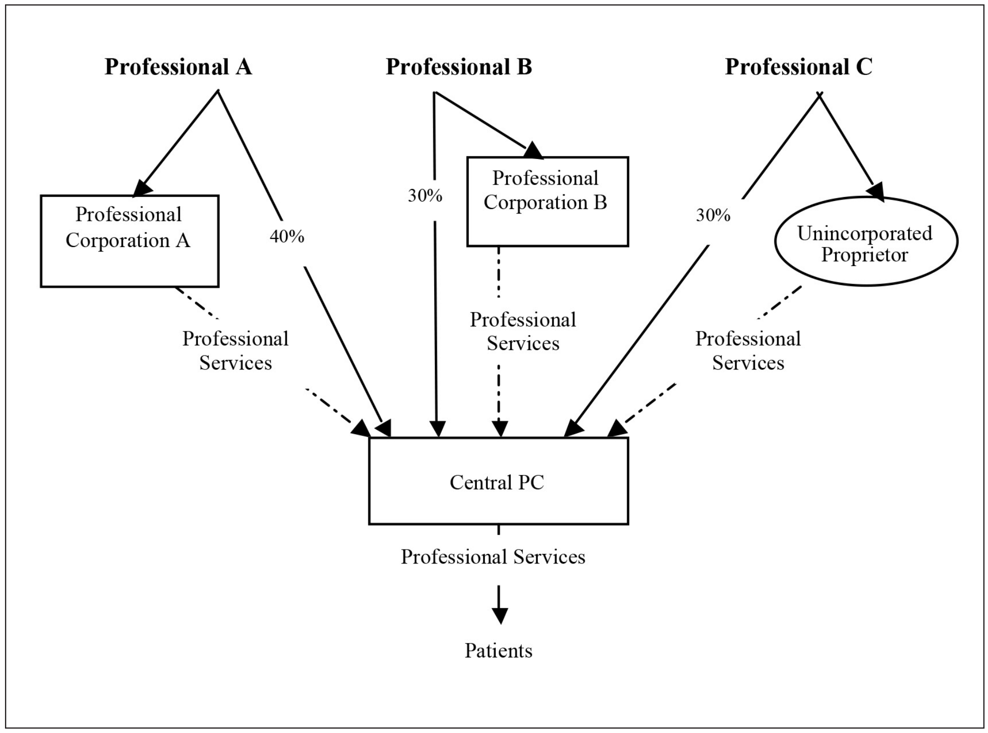
Over the past decade, every province has enacted legislation that allows health-care professionals to practice through a corporation. In the past, where professionals preferred to work together in a group practice instead of working alone, the partnership structure was the only option. However, new structures have evolved to allow the use of PCs in group practices and, where possible, the structure is set up so that each PC in the group practice can have access to its own small business deduction.

The non-tax advantages to these types of structures include:

- Allowing the practice to better attract and retain qualified professionals;
- Eliminating the joint and several liability that is inherent in providing professional services through a partnership;
- Providing a vehicle through which a professional may, if he or she so wishes, provide professional services external to the group practice;
- Increasing business efficiency for each professional by allowing individual management of his or her personal practice;
- Permitting each professional to have control over certain expenditures, such as expenses which may not be in the interest of all participants in the practice;
- Providing each professional with more options and more control when engaging in estate and succession planning; and
- Making it easier for professionals to enter and exit the practice.

The following are two common examples of these structures:

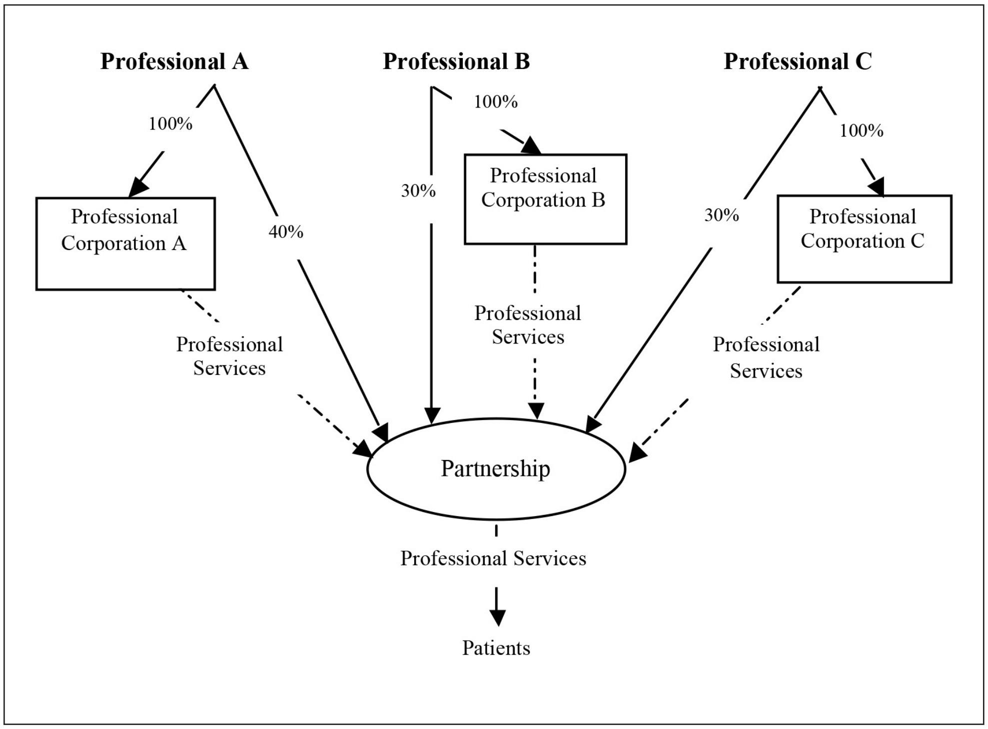
Example I – Structure with a Central PC



This structure contemplates carrying on a professional practice through a "Master" or "Central" PC rather than through a partnership. The individual professionals are shareholders of the Central PC and they enter into a shareholders agreement which provides that Central PC carries out a professional practice by entering into contracts for professional services with independent contractors. The shareholders agreement would also provide that the net profits of Central PC be available for distribution in the form of dividends. Central PC enters into professional services agreements with each professional's individual PC, or with the individual if they are operating as an individual proprietor. The intended goal is that the relationship between Central PC and each PC or individual proprietor is that of an independent contractor-hirer relationship where the contractors are paid a per diem rate and are responsible for paying their own expenses. Each individual PC potentially has access to a small business deduction and the Central PC may also take advantage of the small business deduction.

It should be noted that the Central PC structure and the Hybrid Structure are more complex structures that require careful planning and structuring in order to be effective.

Example II – The Hybrid Structure



In this structure, each individual professional forms their own corporation and each professional holds their partnership interest personally. Each professional controls his or her own PC. The professionals' individual PCs then enter into professional services contracts with the partnership. The individual professionals provide their professional services to the partnership through their own respective PCs.

It should be noted that the Central PC structure and the Hybrid Structure are more complex structures that require careful planning and structuring in order to be effective. Also, there is a risk that the Canada Revenue Agency (CRA) may challenge these complex business structures and among other things, disallow the small business deduction to each PC on the following basis:

- Each PC is not earning active business income but rather earning income from a "personal services business" as the professionals are in fact "employees" of the Central PC or partnership;
- The PCs are deemed associated and must share one small business deduction

A solid business plan will help you indentify how much you need to borrow, how to allocate resources, and opportunities for growth.

because one of the main reasons for the existence of two or more corporations was to reduce the amount of income taxes payable; or

- The PC is earning "specified partnership income" and therefore all of the professional corporations must share one small business deduction with respect to the partnership income.

In the past, the CRA has issued favourable rulings on these types of structures but these rulings and their opinions are based on the underlying facts of each situation and may not be applicable to your specific circumstances. You should assess the risks of operating your practice using these structures with your qualified tax and legal advisors.

Financing

Whether you start your own practice, buy into a partnership or buy out an existing owner, you may need help with financing the start-up costs or purchase price of your practice.

If you are starting out on your own, you will need to prepare a business plan to present to the lending institution. The typical business plan includes a current balance sheet and projected financial performance, an income statement and a cash flow analysis. A solid business plan will help you indentify how much you need to borrow, how to allocate resources, and opportunities for growth. The bank offering you the loan will also be interested in information about your business and how you plan to repay the loan.

If you are buying into an existing practice, structuring the buy-in is usually the most important part of the arrangement. The existing partners or shareholders may either expect you to pay up-front for the partnership interest or PC shares or allow you to pay for same over a few years with interest.

Whether you are borrowing for the buy-in or purchasing an existing practice, the lending institution will want to know the value of the practice and review the projected financial statements to determine how much financing to provide you for the purchase. Alternatively, the seller may wish to assist you with vendor-financing.

For the most part, the health-care industry is considered a lower risk industry for many banks. As a result, banks have generally offered very good terms and pricing on financing based upon the assessment of the business plan and an evaluation of the transaction you are contemplating. Speak to your RBC advisor or RBC health-care specialist for more information about financing options for practice acquisition and advice on practice financial management.

Valuation

Depending on what it is you are purchasing, whether it be an interest in a partnership, shares of a corporation or assets of a business, the valuation of your target purchase is based on a number of factors. All valuations are subjective. As such, before determining a purchase price, you should obtain a valuation of the target business or assets from an independent third party that is qualified to do business valuations.

The expense to obtain a valuation will often be well worth the cost, especially if the value of the business is determined to be far less than the price you had planned to offer prior to obtaining the valuation.

If you are planning on joining other professionals in a group structure, you should ensure you understand the terms and conditions of the shareholders' agreement or partnership agreement and are in agreement prior to finalizing the deal.

Due Diligence

If you are planning on buying into a practice or partnership or purchasing an existing practice, you will need to research the entity's viability and develop a business plan. The benefits of knowing what you are purchasing will likely outweigh the costs of researching the target practice.

Shareholders'/Partnership Agreement

If you are planning on joining other professionals in a group structure, you should ensure you understand the terms and conditions of the shareholders' agreement or partnership agreement and are in agreement prior to finalizing the deal. A shareholders' agreement is an agreement among some or all of the shareholders of a corporation, which among other things, set out the rules relating to the governance of the corporation, dividend policies, funding requirements and dispute resolution. The shareholders' agreement may also contain a buy-sell provision dealing with exit strategies upon the occurrence of an agreed-upon sale event. A partnership agreement is a contract between two or more persons, including corporations, which defines the partnership and the rights and obligations of the partners. It is recommended that you have a lawyer review the agreement to provide you with the right guidance.

Seek the Right Advice

While the next step for an experienced medical or dental professional may be to operate their own business, you may not have the legal, accounting, or practice management background required to run the practice. The fees you pay your professional advisors may actually help you save money and reduce your risks in the long run as they may be able to better engage in reviewing and negotiating contracts, and tax planning for your circumstances. Also, a good practice management consultant can help you establish efficient systems and educate you on how to run a dental or medical practice. Lastly, engaging a qualified financial planner will enable you to grow your wealth for the future. If your situation is relatively complicated then you may want to speak to your RBC advisor about having a comprehensive financial plan prepared. A comprehensive financial plan should address all aspects of your financial affairs, including cash and debt management, tax and investment planning, risk management, and retirement and estate planning.

Please contact us for more information about the topics discussed in this article.