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Incorporate or Not?

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As owner of a sole proprietorship, you may be reading or hearing a lot about the benefits of incorporating. While it's true that incorporating is good for some, not all businesses will necessarily benefit from this move. That's why if you're considering incorporating your business, you should take some time to find out about both the advantages and possible costs of incorporation.

Is your business ready for incorporation? This article highlights some tax planning pros and cons that will help you answer this important question.

What should you ask yourself when considering incorporation?

Is your business profitable enough? Generally in the first few years of operation, a business generates losses due to high start-up costs and/or the cost of building a sales base. As the owner of your business, as long as you're not incorporated, you can use your business losses to offset other sources of personal income, assuming the business is not a "personal endeavour" (i.e. hobby).

If your business is incorporated, any business losses must be applied to the corporation's income and cannot be used to offset personal income. Corporate business losses, however, can be carried back three years or forward for 20 years before they expire and become worthless.

Is the business producing more income than it needs? If so, then incorporating may allow you to "split income" (i.e. pay dividends to other adult family shareholders) and take advantage of tax deferral opportunities due to the small business deduction (see below). Little to no benefit is gained from paying all the company's profits, whether by salary or dividends, to the owner-manager.

Will you really pay lower taxes as a corporation? Incorporated small businesses enjoy a greatly reduced tax rate on the first $400,000 of "active income" (i.e. income received for services such as salary and commission) due to the small business deduction for the years after 2006. The government's goal of the small business deduction is to decrease the tax burden on small businesses to free up more capital for reinvestment, resulting in greater economic opportunity and job creation.

To illustrate, the combined federal and provincial corporate tax rate that businesses are charged is about 20% on the first $400,000 of income. The top marginal personal tax rate is about 48%, which applies to taxable income over $124,000. (Keep in mind the tax rate varies in each province of residence.) This allows an incorporated business to reinvest more capital. However, this is only a tax deferral. When the funds are ultimately paid out of the corporation, either by way of dividend or salary, the business owner must pay full income tax at the personal rate.

The small business deduction is available for active income only, not investment income earned by the corporation.

Are you considering retiring or succession planning? Incorporating your business can reduce or defer your taxes later on. Two common methods used are:

Ensure your business qualifies as a small business corporation. A portion of any gain on the sale of the shares could be exempt from tax by way of the capital gain deduction. Up to $750,000 of the capital gains can be sheltered using this enhanced capital gain exemption.

The $750,000 capital gain exemption is not available if a sole proprietor sells assets of their business since they are selling the assets not the shares of the business. However, it is possible for a sole proprietor to be eligible for the $750,000 capital gain exemption if, anticipating the sale, they incorporate immediately before the sale and then sell the shares of the corporation.

Freezing your estate. This is a process whereby the future growth of a company is transferred to other family members but the control remains with the original owner. This process can have two results:

i. You can transfer future tax liability from the growth of the company to your beneficiaries.
ii. You can multiply the uses of the $750,000 capital gains exemption for small business owners.

Expense Myth: Many people believe that you can write off more expenses if you incorporate your business. In fact, you are still limited to writing off those expenses that were incurred to produce the income. However, incorporation usually incurs higher annual legal and accounting expenditures than sole proprietorship

Other considerations

Limited liability: Since a corporation is viewed as a separate legal entity, the creditors of the corporation cannot generally seize the personal assets of the owner-manager unless the owner-manager gives personal guarantees for loans of the corporation.

Tax holiday: In several provinces, newly incorporated businesses are offered up to three years of income or sales tax relief.

Non-taxable benefits: A corporation can offer benefits that are not available to sole proprietors such as group disability, health insurance and a registered pension plan.

Additional costs: A corporation is required to file its own tax returns and hold annual shareholder meetings. This leads to higher annual administration, legal and accounting expenditures.

Capital tax: Some provinces require some corporations to pay tax on a portion of their capital. Taxable capital is a corporation's share capital, retained earnings, contributed surplus and most liabilities, excluding specified eligible investments. Something to be aware of — as capital tax is not based on profits; it is possible that a corporation will have a capital tax liability, even if the company has income losses in the current year. However, if the assets are less than a specified threshold, no capital tax is payable. In most jurisdictions, capital tax is being phased out and the thresholds are becoming quite high, so this won't affect most people contemplating incorporation. If you are considering incorporating your business, you should discuss these issues in detail with a qualified tax advisor.