THE NAVIGATOR

INCORPORATE OR NOT?

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 considered and that action is taken on the most recent information available.

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 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 against 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 members who are also shareholders of the corporation) and take advantage of tax deferral opportunities since active business income earned in a corporation is taxed at a much lower rate than business income earned personally (see below). Little to no benefit is gained from distributing all of 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 greatly reduced federal and provincial tax rates on the first $500,000 of "active business" income (i.e. income earned from regular business operations or income from an adventure or concern in the nature of trade and not investment income or income earned as an incorporated employee). For incorporated small businesses in Manitoba and Nova Scotia, only the first $400,000 of active business income

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benefits from the reduced provincial tax rate. The government's goal of the small business rate 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, for 2012, the combined federal and provincial corporate tax on income subject to the small business rate ranges between approximately 11% and 19%. The top marginal personal tax rate is between 39% to 50%, depending on your province of residence, which applies to taxable income over $125,000. The lower tax rate 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.

Are you considering retiring or succession planning? Incorporating your business can reduce or defer your taxes as part of your retirement plan. 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 gains deduction. Up to $750,000 of the capital gain can be sheltered using this exemption.

The $750,000 capital gains exemption is only available on the sale of qualified shares of a corporation (i.e., this is not available to a sole proprietor selling the assets of their business). However, it is possible for a sole proprietor to be eligible for the $750,000 capital gains exemption if, anticipating the sale, they set up a corporation and transfer their business to the new corporation immediately before the sale and then sell the shares of the new corporation. The sole proprietor does not need to hold onto the shares of the new corporation for 24 months prior to the sale in order to claim the capital gains exemption in this case.

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, if the owner so chooses. This may enable you to:

1. Transfer future tax liability on the growth of the company to your beneficiaries.
2. Multiply the use of the $750,000 capital gains exemption for small business owners.

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Expense Myth: Many people believe that you can write off more expenses if you incorporate your business. This is not the case as you are still limited to writing off those expenses that were incurred to produce income. In fact, an incorporated business usually incurs higher annual legal and accounting expenditures than a business operating as a sole proprietorship.

Other Considerations

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

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 costs.

Personal Use of Corporate funds: As a sole proprietor, all the business income you earn is taxed in your hands annually; therefore, you can use the after-tax profits however you wish. On the other hand, if you incorporate your business, after-tax profits belong to the corporation and as such, you cannot use corporate funds for personal expenses unless you first take money out of the corporation using a legitimate method such as paying yourself a salary, bonus or dividend. Using corporate funds for personal expenses can result in negative tax consequences such as an imputed interest benefit or a shareholder loan benefit being added to your income.

Please contact us for more information.

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