Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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# Wealth planning for health-care professionals – Starting out on your own

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. This article addresses some of the 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 terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of a CCPC can be listed on a designated stock exchange.

## 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 the potential for the loss of existing patients due to the transition.

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

## Different business structures

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

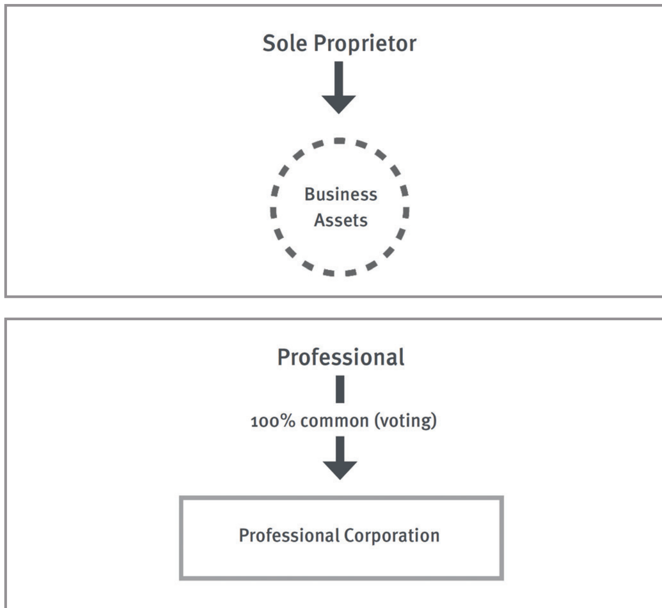
## Features of different business structures

| | 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 they operate. | 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 and other allowable expenses) 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




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 generally be indifferent to running your practice as a sole proprietorship or through a corporation.

When you start your practice from scratch, you can become a sole proprietor or a shareholder of your own professional corporation (PC).

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" (ABI) for tax purposes and be subject to a general federal corporate tax rate of 15% plus the applicable provincial or territorial corporate tax rate. Further, if your corporation is a CCPC throughout the tax year, your corporation may benefit from the small business deduction (SBD) which lowers the federal tax rate to 10% for 2018 and 9% for 2019 on its first $500,000 of ABI (known as the "business limit"). All provinces and territories also provide a SBD and have a business limit. The business limit must be allocated between associated corporations[1] in a taxation year.

As a result of these lower corporate tax rates for ABI, if you incorporate your practice, you may have more after-tax business income to invest inside your corporation. Due to the larger amount of starting capital, you may realize after-tax returns that exceed what you may have realized in a personal investment account. In an attempt to limit this tax deferral benefit for corporations, the federal government has introduced rules to restrict access to the SBD for CCPCs that have significant income from passive investments.

For taxation years that begin after 2018, a CCPC will have its federal business limit reduced on a straight- line basis where the CCPC and its associated corporations earn between $50,000 and $150,000 of passive investment income in a year. The business limit will be reduced by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit will be eliminated if a CCPC, and its associated corporations, earn at least $150,000 of passive investment income in a year. As such, you may want to ensure that the passive investment income earned in your PC does not grind down your business limit.

The provincial or territorial business limit may also be reduced for CCPCs that have significant income from passive investments. Please confirm the specific rules of your province or territory of residence with a qualified tax professional.

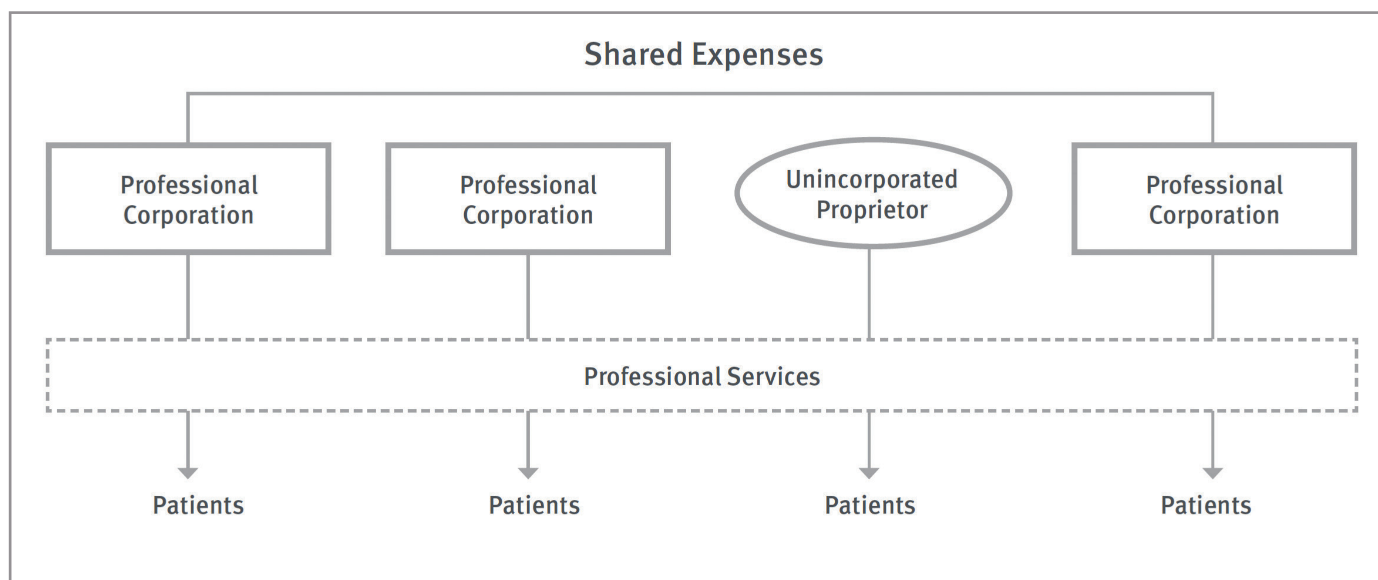
1) The term "associated corporations" is defined in the Income Tax Act. The definition is complex and is beyond the scope of this article.

In addition to the reduction described above, the business limit is reduced on a straight-line basis for a CCPC and its associated corporations where the group has between $10 million and $15 million of total taxable capital employed in Canada. The actual reduction of a corporation's business limit is the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income.

For a more detailed discussion on how the passive income affects your PC's ability to claim SBD, please ask an RBC advisor for our article, titled "Passive Investment Income in a Private Corporation".

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.

## B. Cost Sharing Arrangement

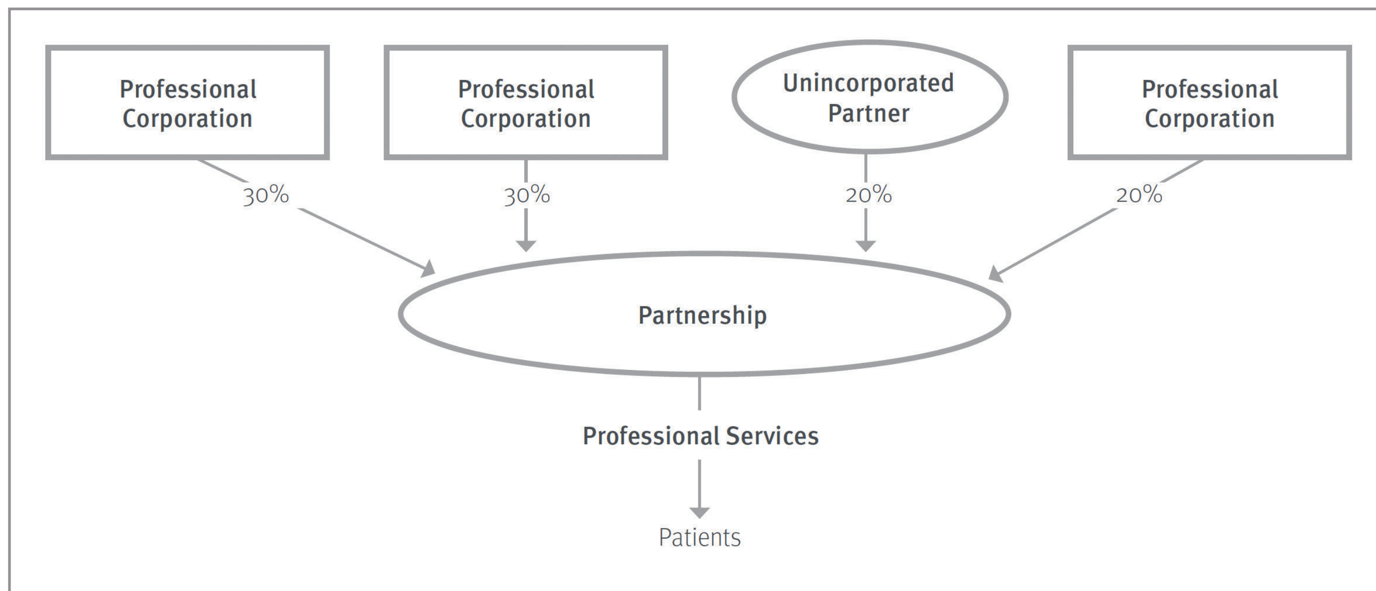



Cost sharing arrangements are very common in the dental and medical professions due to commercial and tax advantages. Under a cost sharing arrangement, the professionals earn their own revenues but split costs for things such as facilities, staff, and other common costs. This arrangement allows the group of professionals to share the administrative and office costs as well as certain capital expenses, such as major equipment or office renovations. This arrangement provides the professionals with most of the advantages of an individual practice while allowing them to benefit 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 SBD on their own taxable income.

It is very important that a cost sharing arrangement is not viewed as a partnership. Otherwise, you will have to share the SBD 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 SBD 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 SBD 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 SBD federally, calculated as your 25% share of the SBD (provincial SBD is calculated accordingly). The remaining allocated partnership income will be taxed at the general corporate tax rate depending on the province of residence. The PC is still entitled to the full business limit, so additional ABI of up to $375,000 federally and corresponding provincial ABI could be earned by the PC from other sources and qualify for the lower corporate tax rate.

### 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 identify how much you need to borrow, how to allocate resources and opportunities for growth.

If you are buying into an existing practice, structuring the buy-in is usually the most important part of the arrangement. The buy-in can be structured in a number of ways, for example, the existing partners or shareholders may allow 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.

## 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. 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.

## 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.

The fees you pay professional advisors may 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.

## 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 professional advisors may 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, consider engaging a qualified financial planner to have a comprehensive financial plan prepared which should address all aspects of your financial affairs, including cash and debt management, tax and investment planning, risk management, and retirement and estate planning.

*This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.*

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