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ESTABLISHING A PROFESSIONAL CORPORATION IN ONTARIO

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Various professional bodies, in conjunction with legislative changes made by the Ontario government, now permit their members to incorporate their practices. The professionals who are able to now incorporate include doctors, dentists, lawyers, chartered accountants, pharmacists and veterinarians. The primary purpose for this change is to enable these professionals, who have traditionally carried on business as sole proprietorships or as partnerships, to benefit from certain tax-planning opportunities generally available to other entrepreneurs through the use of corporations.

The purpose of this memorandum is to provide an overview of some of the general benefits and drawbacks to professional incorporation. In addition, this memorandum will outline various considerations that should be taken into account before establishing a professional corporation ("PC").

Unlike typical corporations, PCs do not provide limited liability protection from professional liability to the shareholders. The professional is jointly and severally liable with the PC, in respect of errors and omissions that were made or occurred, while the individual was a shareholder of the PC. In addition, all of the issued and outstanding shares of the PC must be legally and beneficially owned, directly or indirectly, by one or more members of the same profession. Furthermore, all officers and directors of the PC are required to be shareholders of the corporation. Due to these legal requirements, income splitting opportunities with other family members is significantly diminished.

The PC must not carry on business other than the practice of the profession. This requirement, however, will not be construed to prevent the PC from carrying on activities that are related to, or ancillary to, the practice of the profession, including the investment of surplus funds. Furthermore, the name of the PC must include the words "Professional Corporation", and the PC cannot be a numbered corporation.

BENEFITS OF INCORPORATION

1. Income Tax Deferral and Savings Opportunity

The opportunity for income tax deferral and savings is the main reason why a professional would consider incorporating his or her practice. To the extent that a professional does not withdraw the PC's after-tax funds, a significant tax deferral benefit can be achieved. In calendar 2003, the PC is subject to a combined federal & Ontario corporate tax rate on the first \$ 225,000 of taxable income (referred to as the "Small Business Limit") of 18.62%, compared with the top marginal personal tax rate of 46.41% which would apply to a non-incorporated professional who is a resident of Ontario. By calendar 2006, the Small Business Limit for corporations is scheduled to increase to \$300,000 and the applicable combined corporate tax rate is set to decline to 17.12%. Where the business is carried on as a partnership, the professionals can choose to either (i) incorporate the partnership, which would then be carried on as a PC, or (ii) transfer their partnership interests to separate PCs, which would carry on business as a partnership of corporations. In either case, only one Small Business Limit would be available in respect of the income of the business.

In addition to the tax deferral opportunity, there is also a small tax savings to be realized by the professional when the PC's entire after-tax income is withdrawn.

The calendar 2003 tax deferral opportunity and permanent tax savings are illustrated in Schedule 1 attached to this memorandum. The Schedule indicates that if precisely \$225,000 of taxable income is earned by the PC, rather than being earned personally by the professional, the corporation would enjoy an immediate tax deferral benefit of \$ 62,528. The after-tax earnings of the PC can be used to finance the practice or to make investments, or any combination thereof. When the corporation ultimately pays a dividend to the professional, the personal tax thereon will amount to \$ 57,385. Accordingly, even if the PC does not defer the payment of the dividend to the professional, there is still an overall tax savings of \$5,143.

2. Tax Savings by Removing Corporate Profits as Capital Gains

In limited cases and with proper planning, arrangements can be made to remove the after-tax corporate profits by means of a capital gain transaction, rather than a dividend. This allows for an additional income tax savings of approximately 8%, since capital gains are taxed at a top marginal rate of 23.20% to an Ontario resident, whereas dividends are taxed at a top marginal rate of 31.34%.

3. Capital Gains Exemption

Should a professional arrange to sell his or her practice via a sale of the PC shares, it may be possible to shelter up to \$ 500,000 of the resulting capital gain from tax. This tax benefit may, alternatively, be realized by the professional's estate to minimize taxes upon his/her death. The exemption, however, will not be available in certain situations, such as

where the PC retains investment surplus beyond certain threshold levels or where the professional has a “cumulative net investment loss” account. In some situations, planning can be undertaken so that the professional could avail him/herself of the exemption.

4. Tax Installments

The PC would not be required to make installment payments in its first taxation year, thus providing a cash flow advantage for that fiscal year.

5. Ability to Fund Corporate Life Insurance

The PC can fund the premiums of a life insurance policy on the life of the professional, provided the PC is the named beneficiary under the policy. Although the premium would not be deductible to the corporation, it can be paid out of the corporation’s after-tax funds without any personal tax implications to the professional. Life insurance proceeds received by the PC upon the professional’s death would be received by the PC on a tax-free basis. In addition, the proceeds received in excess of the policy’s *adjusted cost base* can be paid on a tax-free basis to the professional’s estate.

6. Limited Liability

Although a PC does not provide protection against liabilities arising from malpractice, it may provide protection from liabilities arising in other areas, such as lease obligations, amounts owing to suppliers, etc.

7. Remuneration Flexibility

A professional who carries on business as a sole proprietor or a partner will have his/her income taxed in one form only, namely self-employment income. Through a PC, however, a professional has the flexibility to receive his/her remuneration either in the form of salary (which is taxed in a similar fashion to self-employment income) or dividends, or any combination thereof. The choice of such remuneration would be determined in consultation with one’s accountant.

It should be noted that it is possible for the PC to obtain a deduction for an accrual of unpaid salary/bonuses to the professional, provided that it is actually paid within 179 days of the PC’s fiscal year-end and the related source deductions are remitted within the appropriate time frame (usually, it is by the 15th of the month following the month in which the salary/bonus is paid). The accrual of salary enables the PC and the professional to enjoy a tax deferral of up to six months.

In addition to the foregoing, the professional is also able to access the PC’s surplus through a shareholder loan. Provided the loan is repaid by the end of the taxation year following the taxation year in which the loan is made by the PC, and provided the loan repayment is not part of a series of loans and repayments, there would not be any income tax consequences to the professional, save and except for the inclusion in taxable income of an imputed interest benefit based on the *prescribed rates of interest* in effect while the loan

was outstanding. Therefore, through the use of a shareholder loan, it would be possible to defer the recognition of remuneration to a subsequent calendar year from the year in which the corporate funds were received, since a salary or a dividend would likely be required to be paid in the following year in order to repay the corporate loan.

8. Ability to remove capital through tax-deductible financing

On October 2, 2002, the Canada Customs and Revenue Agency (“CCRA”) provided an update on interest deductibility issues. In that update, the CCRA accepted the deductibility of interest when a borrowing is incurred in order to return capital of a partnership. This position, however, does not extend to a sole proprietor who borrows money to extract capital to be used for his/her personal living needs. By incorporating, the sole proprietor could transfer the business to a PC in exchange for consideration that includes a shareholder loan, equal in amount to his/her capital computed on a tax basis. Should the PC borrow to repay the shareholder loan, the interest expense would be deductible to the corporation, since, in effect, one debt is being substituted for another. Therefore, by incorporating, tax deductible interest can result in such circumstances, since interest deductibility to the PC is not impacted by the personal usage of the funds by the individual. Incorporation for this reason could be of particular benefit to professionals who have significant fixed assets in their practise, such as dentists or certain physicians.

9. Canada Pension Plan (“CPP”)

Where a professional operates as a sole proprietor or as a partner, CPP must be paid in respect of his/her self-employment income, whether or not such income is distributed to the professional. For 2003, the CPP rate on self-employment earnings is 9.9% on pensionable earnings of \$39,000, subject to a basic exemption of \$3,500. Therefore, for 2003, the maximum CPP payable by the professional is \$3,603.60. For income tax purposes, half of the CPP paid by the professional is tax deductible, while the other half is allowed as a personal tax credit.

Through a PC, where the professional draws less salary than the maximum pensionable earnings for the year, CPP savings would be realized both by the PC and the professional. Of course, the professional would likely receive reduced CPP pension benefits upon his/her retirement.

10. Employment Insurance (“EI”)

If the professional (and related persons) owns less than 40% of the voting shares of the PC, the employment may be insurable. This could be beneficial if the professional is able to derive EI benefits (e.g. maternity or paternity benefits). The requirement to pay EI premiums would increase the annual cost of doing business as a PC.

11. Private Health Service Plan (“PHSP”) Premiums

A professional who pays PHSP premiums is permitted to deduct such premiums against his/her self-employment income, but subject to certain restrictions and conditions contained

in the Income Tax Act (the “Tax Act”). Such restrictions and conditions do not apply to corporations that pay PHSP premiums for the benefit of their employees. Furthermore, the payment of PHSP premiums by an employer does not constitute a taxable benefit to an employee.

12. Death Benefit

A \$ 10,000 tax-free death benefit may be paid out of a corporation to an employee’s surviving spouse or the employee’s estate on the death of the employee. The death benefit is deductible to the corporation.

DRAWBACKS OF INCORPORATION

1. Costs of Incorporation

The process of incorporation is relatively simple, but will require the services of a lawyer and an accountant. A transfer agreement will be required with respect to the transfer of the business to the PC. Depending on the situation, a professional valuation may be required. The estimated total fees (including professional fees, government filing fees and professional body fees) would likely be in the range of \$ 4,000 to \$ 8,000, plus GST, depending on the complexity of the situation. Provided certain elections are timely filed, there would not be any income tax, GST (except in respect of the supply of real property or leasehold improvements by a GST exempt supplier, such as a physician or dentist) or Ontario Retail Sales Tax arising upon incorporation.

2. Additional Annual Administrative Costs

A professional corporation is considered to be a separate taxpayer and, therefore, must file both federal and Ontario income tax returns. The extra filings and the tax planning would result in additional annual professional fees, together with annual charges by the professional body, of approximately \$ 2,000 to \$ 3,000, plus GST, depending on the particular situation.

In addition, given that a corporation must file Ontario tax returns in addition to federal tax returns, incorporation will result in the potential for additional scrutiny of the professional’s business activities i.e. the Ontario Ministry of Finance could audit the business, not merely the Canada Customs and Revenue Agency (“CCRA”). Currently, Ontario resident individuals only file federal returns, and the administration of such filings is solely attended to by the CCRA.

3. Employer Health Tax (“EHT”)

Individual professionals are not required to pay EHT, regardless of the quantum of the income earned. However, EHT will apply where a PC, together with its associated corporations, pays salaries in excess of \$400,000 in a year. The EHT rate is 1.95% of salaries in excess of \$400,000, but such EHT is tax-deductible to the PC.

4. Asset Protection

An individual professional may invest his/her after-tax funds in certain investment products that offer asset protection, in that they generally cannot be seized by a creditor of the individual e.g. segregated mutual funds and life insurance policies of life insurance companies. An asset protection objective would not be achieved where the PC's after-tax funds are invested in such products, since the professional would not own these investments directly, but would instead own shares of the PC, which would be available to creditors.

5. Losses

Should a professional suffer a business loss, it may be utilized to offset all other sources of income for the year. Should the PC suffer the loss, it may not be flowed out to the professional. Therefore, should the PC not have any other sources of income for the year, such as investment income, the only tax relief available to the corporation would be to carry back the loss against its income for its previous three taxation years, if any, or to carry forward the loss to the following seven taxation years against its income in those years.

6. Tax Installments

For individuals, income tax installments are due quarterly, on the 15th day of the relevant month. For corporations, income tax installments are generally due monthly, on the last day of the particular month.

OTHER CONSIDERATIONS ASSOCIATED WITH INCORPORATION

1. If a professional is a member of a partnership, the professional's partnership interest can be transferred to the PC on a tax-deferred rollover basis. The PC's allocable share of the partnership income would only be subject to the low corporate tax rates, however, only to the extent of the product obtained when the Small Business Limit is multiplied by the PC's profit/loss sharing interest of the partnership. In addition, the partnership will be required to have a December 31 fiscal year-end, if it does not currently report income on a calendar year basis.
2. A PC that is not a partner in a partnership may choose any fiscal year-end. A PC that is a partner in a partnership, however, must have a December 31 fiscal year-end. A non-incorporated professional can choose to report his/her self-employment income on a calendar year basis or on a non-calendar fiscal year basis, subject to the "alternative election".
3. A professional who is an employee (as opposed to a proprietor or partner) should not incorporate with the expectation that their employment income would be earned and taxed in the PC. There are rules contained in the Tax Act which would yield adverse income tax consequences under such circumstances. Where the employee professional, however, also has his/her own practice, a PC may be established for his/her self-employment income.

4. Where a PC is used, the professional may achieve tax benefits by purchasing or leasing the automobile in the corporation. The rules associated with the usage of an automobile by an employee of a corporation for the provision of his/her employment duties are lengthy and complicated. The articulation of the Tax Act's automobile rules are beyond the scope of this memorandum.
5. Incorporation may cause the "association" of the PC with any other corporations that may be owned by the professional and/or other family members. The consequences of the Tax Act's association rules are beyond the scope of this memorandum.
6. Where a professional carried on a business with a non-calendar fiscal year end prior to 1995, he or she is entitled to claim a reserve in order to bring into income the tax deferral over a ten-year period. When an individual transfers his/her professional practice to a corporation on or after January 2, 2003, the ability to claim the reserve will be unaffected.
7. Where a partnership is incorporated, the professionals should consider entering into a unanimous shareholders' agreement to set out their respective rights and obligations.

CONCLUSION

There are significant tax advantages available to a professional who chooses to incorporate his or her practice. The benefits of incorporation will outweigh the drawbacks in most cases, particularly where the professional does not require all of his or her professional income for personal expenditures.

The information in this memorandum is general in nature. We recommend that you contact your partner at Goldfarb, Shulman, Patel & Co. LLP, to discuss the potential benefits of incorporating in your situation.