

Professional Corporations —Is One Right for You?

Recent and planned corporate income tax rate reductions mean that now is a good time for professionals to consider incorporating their practices. The low corporate tax rate (which, since January 1, 2005, is available on \$300,000 of corporate income), flexibility in respect of remuneration and access to the \$500,000 capital gains exemption make this option especially attractive. All provinces allow certain professionals to incorporate, extending to these professionals many of the non-tax and tax advantages of incorporation enjoyed by other incorporated self-employed individuals.

This *Tax Memo* summarizes issues professionals face when considering incorporation. Whether incorporation is right for you is a multi-faceted and complex decision that depends on your personal circumstances. To decide, contact your PricewaterhouseCoopers adviser or any of the individuals listed on page 8.

Contents

Professionals Who May Incorporate.....	1	Other Considerations	5
Restrictions.....	1	Summary.....	6
Tax Advantages	2	Appendix: Income Tax Rate Tables	7

Professionals Who May Incorporate

Typically, only those professions that are governed by a professional body or association as provided by law can incorporate a professional corporation. This generally includes accountants, architects, engineers, lawyers, physicians, dentists and veterinarians, among others. For example, in Ontario, the right to incorporate is also granted to social workers, social service workers and regulated health professionals. The relevant provincial legislation should be consulted.

Restrictions

Professional corporations face special corporate law issues because they are usually governed by specific provincial legislation. Some restrictions are considered below.

No limited liability for malpractice

We recommend consulting a lawyer to determine what structure best meets your liability concerns before incorporating a professional corporation.

Unlike most other corporations, professional corporations typically do not insulate their shareholders from liability for professional malpractice claims against the corporation. Professionals concerned with personal malpractice exposure will often operate in a limited liability partnership. Nevertheless, an incorporated professional may be able to achieve limited liability with respect to other business dealings (e.g., trade payables, lease liabilities and non-guaranteed bank loans) to the extent that he or she has not personally guaranteed payment.

Ownership

In some jurisdictions (e.g., Alberta), only members of the same profession may be shareholders. In these cases, multi-disciplinary professional corporations are not permitted and family members who are not members of the profession cannot be shareholders. Although both these restrictions currently exist in Ontario, Ontario's 2005 budget proposed that

Ontario permit family members to hold non-voting shares in a physician's or dentist's professional corporation.

Legislation often requires that the majority or all of the directors (and sometimes officers) be professionals licensed under the relevant legislation. In addition, the legislation may refer to indirect ownership of shares by professionals. When indirect ownership is permitted, a holding company can be used to remove passive assets from the professional company on a tax-deferred basis, leaving only income eligible for the small business deduction in the corporation, and allowing the corporation to meet the requirements for the capital gains exemption (both of which are discussed later).

Other restrictions

The provincial statute and the rules of the governing professional body should also be reviewed for restrictions on the corporation's name and business activities. For example, in Ontario, the only business that the corporation may carry on is the practice of the profession, including activities ancillary to the practice (e.g., the temporary investment of the corporation's surplus funds).

A professional corporation may require certification by the professional governing body that has jurisdiction over it. Each governing body is responsible for establishing its own certification procedures. In addition, governing bodies may "look through" the corporation to hold the professional shareholders accountable.

A professional seeking to incorporate should review the rules established by the governing organization to ensure initial and continuing compliance and that ongoing information requirements are met.

Tax Advantages

The most compelling reason for incorporating is to benefit from the tax advantages available to corporations. Incorporation also enhances remuneration flexibility and may provide access to the capital gains exemption.

Deferring tax

The main tax advantage of incorporating is the ability to defer tax by retaining, in the corporation, income that is subject to low corporate tax rates. This advantage will be optimized if \$300,000 of professional income is retained in the corporation annually. If the professional personally requires all the corporate funds, the tax advantages of incorporating may not merit the costs of forming and administering the corporation.

In general, the opportunity to defer tax arises because corporate tax rates on professional income up to \$300,000 are substantially lower than personal tax rates. The spread is expected to widen in some provinces. This is illustrated in the **Appendix** (page 7), which provides combined federal/provincial corporate income tax rates on professional income and combined federal/provincial marginal personal income tax rates.

The amount of funds that should be retained in a corporation depends on the combined corporate/personal tax that will ultimately be paid upon the distribution of the funds to the shareholders. Retention of funds in the corporation will be beneficial if the combined tax cost that would result on distribution is not increased. This is generally the case for the first \$300,000 of annual corporate income, but not for corporate income exceeding \$300,000.

Lower rates on first \$300,000 of corporate income

As noted above, the greatest advantage of a professional corporation is the ability to defer tax by retaining \$300,000 of professional income annually in the corporation. As shown in the **Appendix** (page 7), such income will be subject to a special low rate, which for years ending December 31, 2005 ranges from 15.37% to 22.02%, depending on the province.

Table 1 shows the income tax deferral if \$300,000 active business income is earned and retained in a professional corporation as opposed to being earned directly by the professional. It also shows the tax savings (tax cost in Manitoba, New Brunswick and Newfoundland and Labrador) if the after-tax corporate income is paid out as a dividend to the shareholder.

Table 1 \$300,000 Professional income earned using a corporation vs. directly

	2005*	
	Deferral	Savings (Cost)
Alberta	\$68,640	\$8,040
British Columbia	\$78,240	\$180
Manitoba	\$84,840	(\$1,350)
New Brunswick	\$94,410	(\$180)
Newfoundland and Labrador	\$91,560	(\$120)
Nova Scotia	\$90,390	\$9,180
Ontario	\$83,370	\$6,840
Prince Edward Island	\$82,500	\$5,670
Québec	\$78,600	\$1,830
Saskatchewan	\$77,640	\$8,040

* The figures assume the individual pays tax at the top combined federal/provincial income tax rate. The effect of Canada Pension Plan or Québec Pension Plan, which could increase the tax savings and is discussed on page 5, is ignored.

For example, an individual taxed at New Brunswick's top personal tax rate can defer \$94,410 of tax in 2005 by retaining \$300,000 of income in a corporation. The deferral may be even higher in future years because New Brunswick's low corporate rate is scheduled to decrease further in 2006. However, if instead the income is paid out of the corporation as a dividend, there is an ultimate tax cost of \$180.

Restricted access to special low rate

Caution is advised when assessing the possible benefit from the special low corporate rate on the first \$300,000 of professional income. Key concerns are outlined below.

Joint ownership of corporation

To maximize access to the low corporate rate, each professional likely will want to form his or her own professional corporation. If several individuals are shareholders in one professional corporation, the \$300,000 threshold will apply to their cumulative professional income.

Associated corporations

A professional corporation will not want to become associated with any other corporations. Access to the special low rate is limited if the corporation has associated corporations, because associated companies must share the \$300,000 threshold up to which the low rate is applied. In general, this will be a concern if the controlling shareholder of a professional corporation owns at least 25% of the shares of any class of another company that is controlled by persons that are related to the shareholder. Corporations may also be deemed to be associated under special anti-avoidance rules.

Corporate partners

If a professional corporation is a member of a partnership, the corporate partners must share the \$300,000 threshold. In other words, the partnership is entitled to only one \$300,000 threshold, which must be shared by all its partners.

Personal services business

The special low corporate rate does not apply to income from a personal services business (i.e., income earned as an incorporated employee). In addition, only limited deductions may be made from such income. These restrictions may apply if a professional provides employment services, as opposed to professional services, through a corporation.

Specified investment business

Access to the special low rate is also denied to income from a specified investment business (i.e., a business whose principal purpose is to derive income from property). In addition, when the restrictions on permitted business activities preclude a professional corporation from carrying on a specified investment business, these restrictions may eventually be violated if funds are accumulated and invested in the corporation.

It may be feasible to avoid the accumulation of excess funds in the professional corporation by distributing or lending the funds to a non-professional corporation that is related to the professional corporation. However, this might contravene restrictions on the business activities of a professional corporation or it could trigger the application of the income attribution rules. The tax implications of this strategy are complex and should be reviewed carefully. Professional advice should be sought before proceeding.

Corporate income above \$300,000

If more than \$300,000 of professional income is retained in the corporation, tax will be deferred when the applicable corporate rate is less than the professional's marginal tax rate. The deferral advantage increases as the spread between corporate rates and personal rates widens. However, upon withdrawal of the excess, the combined corporate/personal tax liability will be greater than if the income had not been retained in the corporation. As a result, generally it is not advisable to retain more than \$300,000 of income in a corporation annually (unless the funds are retained long enough for the value of the deferral to outweigh the ultimately higher tax cost). Therefore, corporate income exceeding \$300,000 generally would be paid as a salary or bonus.

Non-calendar year end

While sole proprietorships and partnerships must have calendar year ends, a professional corporation may choose a non-calendar year end, thereby providing the opportunity to align the corporate year end with the business cycle. However, a professional corporation that is a corporate partner may not select a non-calendar year end, and therefore lacks this ability.

Tax instalments

The instalment requirements for corporations provide a further tax deferral opportunity because corporate income tax instalments are not required in a corporation's first

taxation year. Thereafter, however, instalments will be payable monthly, rather than quarterly.

Tax effectiveness

It may be more tax effective to have non-deductible expenses (e.g., life insurance premiums) and partly deductible expenses (e.g., meals and entertainment) paid by the corporation rather than by the professional directly. If the corporate tax rate is lower than the professional's marginal tax rate, more after-tax dollars will be available at the corporate level to fund these expenses.

Furthermore, the restrictions for home office expenses apply to individuals and not corporations. In addition, if a corporation is used, a \$10,000 death benefit can be received tax-free by the professional's surviving spouse (and the corporation can deduct the amount).

Remuneration flexibility

Instead of receiving business income from a professional practice, the incorporated professional can choose between salary and dividends. As mentioned, the general rule is that all corporate income over \$300,000 (i.e., all income not subject to the low corporate tax rate) should be paid as salary or bonus (see **Corporate income above \$300,000**, page 3). However, several factors should be considered when determining the professional's remuneration mix. For example:

- professionals may wish to receive sufficient income as salary to make maximum Registered Retirement Savings Plan (RRSP) and Canada Pension Plan (CPP) or Québec Pension Plan contributions (see **Canada Pension Plan/Québec Pension Plan** on page 5); but
- the payment of dividends may be desirable if the professional has a cumulative net investment loss (CNIL) and is seeking to claim the capital gains exemption (see **Access to capital gains exemption**, on this page).

The use of a corporation provides several options to increase a professional's retirement savings. For example, a corporation may make tax-deductible contributions to an individual pension plan (IPP) or it may set up a retirement compensation arrangement (RCA). Contributions to an RCA are subject to a 50% tax, which is refundable to the RCA when it distributes funds to the beneficiary.

Accruals

The professional's tax liability may be deferred if the professional corporation accrues bonuses and/or

employee profit sharing plan (EPSP) contributions. Special rules permit an employer to claim a deduction for accrued remuneration and EPSP contributions, while the employee is not taxable on these amounts until they are actually paid.

Bonus accruals

Accrued remuneration may be deducted in the year the accrual is made, provided the amount is paid within 179 days after the employer's year end. Upon payment, the accrued remuneration will be subject to payroll withholding tax, and in some provinces, payroll tax (see Table 2). If the corporate year end is in the second half of the calendar year (i.e., after July 6), the accrued remuneration can be paid (and taxable to the employee) in either the calendar year in which the accrual is made or the following calendar year. The professional's personal taxes will be reduced if the payment is made in the year his or her marginal tax rate is lower.

Employee Profit Sharing Plan (EPSP) accruals

If an EPSP is formed for the benefit of the professional, EPSP contributions accrued by the corporation may be deducted in the year the accrual is made, provided the contribution is paid within 120 days of the corporation's year end. However, the EPSP contribution is not taxable to the employee until it is allocated to the employee.

If the corporate year end is in the last four months of the year (i.e., after September 3), the accrued remuneration can be allocated (and taxable to the employee) in either the calendar year in which the accrual is made or the following calendar year. The professional's personal taxes will be reduced if the allocation is made in the year his or her marginal tax rate is lower.

An additional advantage is obtained because EPSP contributions are not subject to withholdings (but, may be subject to payroll tax). Therefore, if a professional corporation with a September 30, 2005 year end accrues the expense of contributing to an EPSP and allocates the contribution within 120 days (i.e., by January 27, 2006), the professional would have an income inclusion in 2006 and would not pay tax on the amount until April 30, 2007 (if no installment requirement exists).

Access to \$500,000 capital gains exemption

The \$500,000 capital gains exemption for the disposition of qualified shares of a small business corporation may be available on the sale of shares in the professional corporation or on the shareholder's death. A potential problem is that a purchaser would generally prefer to

acquire the assets of the corporation, rather than shares. Another concern is whether the shares will qualify if significant non-business assets build up in the corporation.

Other Considerations

Incorporation costs

Incorporating a professional practice increases complexity and costs. Additional effort is also required to form and administer a corporation. Although the assets of a proprietorship or partnership generally can be transferred on a tax-deferred basis into a corporation, the transaction is usually complex and consulting your PricewaterhouseCoopers tax adviser is essential. Annual costs after the corporation's creation include the cost of minutes, annual financial statements and corporate tax returns.

Income splitting

A significant advantage of incorporation is the potential to split income. When the legislation permits individuals other than the professional to be shareholders, income may be split through the payment of dividends to non-professional family members. In other cases, family members may be employees and receive reasonable salaries (as is the case for unincorporated professional practices), or the income-splitting strategies discussed below can be used.

Spouse and adult children

In provinces that preclude family members who are not members of the profession from being shareholders or directors, income may be split if the professional's spouse and adult children, directly or indirectly, own shares in a management company that provides services to the professional corporation. Care should be exercised to ensure that anti-avoidance provisions do not cause the management company and the professional corporation to be associated. Alternatively, the spouse and adult children, directly or indirectly as beneficiaries of a trust, could be partners in a management partnership that provides services to the professional corporation.

Minor children

If a trust for minor children owns shares of the management company, the management company and professional corporation could be associated, with the result that the \$300,000 threshold for the low corporate tax rate (discussed under **Deferring tax**, page 2) would

have to be shared between the two companies. In addition, direct or indirect distributions of business income or dividends to minor children could be subject to "kiddie tax" and, therefore, taxable at the top personal marginal rate. For example, kiddie tax could apply to distributions to minor children through a management company or a management partnership.

Payroll Taxes

Four provinces levy payroll taxes. While self-employed individuals are exempt from payroll taxes, a professional corporation will be subject to payroll taxes on its total payroll costs, as follows.

Table 2 Payroll Tax	N/A if payroll under*	Maximum rate
Manitoba	\$1 million	2.15%
Newfoundland and Labrador	\$600,000	2%
Ontario	\$400,000	1.95%
Québec**	No exemption	4.26%

* Associated or related corporations may be required to share the exemption.

** Québec employers with payrolls of \$1,000,000 or more must also contribute 1% of payroll to training.

Employment Insurance (EI)

Self-employed individuals are exempt from Employment Insurance (EI) contributions on their own earnings. If a professional incorporates, his or her earnings will be exempt from EI contributions, provided the professional holds more than 40% of the corporation's shares. If no exemption applies, the maximum employee contribution of \$761 and the maximum employer contribution of \$1,065 are required for 2005 if the employee's earnings are at least \$39,000.

Canada Pension Plan/Québec Pension Plan (CPP/QPP)

For 2005, when the earnings of an employee or a self-employed individual are at least \$41,100, the following rules apply.

Table 3 CPP/QPP		2005
Employee	Employer contribution	\$1,861.20
	Employee contribution	
	Deductible to employer	
	Eligible for employee tax credit	
Self-employment	Self-employed contribution	\$3,722.40
	Deductible	\$1,861.20
	Eligible for tax credit	

Other Québec contributions

In Québec, individuals whose income from certain sources is \$12,075 (in 2005) must contribute a maximum of \$1,000 annually to Québec's Health Services Fund. The contribution gives rise to a tax credit and is imposed on both professional income and dividends, but not on remuneration.

In addition, commencing January 1, 2006, employees, employers and the self-employed must contribute to the Québec parental insurance plan (QPIP). Details concerning the QPIP have yet to be announced.

Withdrawing corporate funds

Any corporate funds removed from the corporation may trigger an immediate tax cost. The corporation must withhold and remit tax with respect to any salary or bonus payments. The use of advances could trigger imputed interest and shareholder loan problems. The payment of dividends will increase the shareholder's tax liability in the current year and may also increase the shareholder's quarterly instalment payments in the current and following year.

Multi-jurisdictional services

Incorporation may increase or decrease the tax paid by professionals who do business outside their province of incorporation. While sole proprietors and partners pay tax on income allocable to the provinces in which they operate based on applicable provincial personal tax rates, corporations pay tax on such income based on applicable provincial corporate tax rates. Bonuses paid by the corporation to the professional will be subject to tax only in the professional's province of residence.

Capital tax

Unlike individuals, corporations are subject to federal and provincial capital taxes on their taxable capital employed in the jurisdiction. However, because most professional corporations will have taxable capital below the federal and provinces capital tax exemptions, capital taxes generally will not be a concern. Federal and provincial capital tax rates and exemptions for December 31, 2005 year ends are shown in the following table.

Table 4 Capital tax	Rate	Exemption*
Federal**	0.175%	\$50 million
Alberta	No capital tax	
British Columbia		
Manitoba	0.3% or 0.5%	\$5 million
New Brunswick	0.3%	
Newfoundland and Labrador	No capital tax	
Nova Scotia**	0.29% or 0.57%	Up to \$5 million
Ontario**	0.3%	\$7.5 million
Prince Edward Island	No capital tax	
Québec	0.6%***	Up to \$1 million
Saskatchewan	0.6%	Up to \$20 million

* Exemptions are generally shared by associated or related corporations.

** Federal, Nova Scotia and Ontario capital taxes are being phased out.

*** Québec's capital tax will be reduced in stages.

Summary

The rules allowing professionals to incorporate are intended to "level the playing field" with other self-employed individuals who can operate their businesses through a corporation. Although the low corporate rate, remuneration flexibility and access to the capital gains exemption appear to make incorporating a professional practice attractive, the appropriateness of this structure will depend on your personal circumstances. The income tax, non-tax and legal implications should be fully analyzed. Contact your PricewaterhouseCoopers adviser or any of the individuals listed on page 8 for an evaluation before you proceed.

Appendix: Income Tax Rate Tables

Table 5 Combined federal/provincial corporate tax rates on professional income (December 31 year ends)

		2005	2006*
Alberta	First \$300,000	16.12%	
	\$300,000 – \$400,000	25.12%	
	Over \$400,000	33.62%	
British Columbia	First \$300,000	17.62%	
	\$300,000 – \$400,000	26.62%	
	Over \$400,000	34.86%	34.12%
Manitoba	First \$300,000	18.12%	
	\$300,000 – \$400,000	27.12%	
	Over \$400,000	37.12%	
New Brunswick	First \$300,000	15.37%	
	\$300,000 – \$425,000	24.37%	
	\$425,000 – \$450,000	29.57%	
	\$450,000 – \$475,000	35.12%	
	Over \$475,000	23.87%	
Newfoundland and Labrador	First \$300,000	18.12%	
	Over \$300,000	36.12%	
	First \$300,000	18.12%	
Nova Scotia	\$300,000 – \$350,000	29.83%	
	\$350,000 – \$400,000	38.12%	
	Over \$400,000		
Ontario	First \$300,000	18.62%	
	\$300,000 – \$400,000	27.62%	
	\$400,000 – \$1,128,519	40.79%**	
	Over \$1,128,519	36.12%	
Prince Edward Island	First \$300,000	19.87%	19.62%
	Over \$300,000	38.12%	
Québec	First \$300,000	22.02%	
	\$300,000 – \$400,000	31.02%	
	Over \$400,000	32.02%	
Saskatchewan	First \$300,000	18.12%	
	Over \$300,000	39.12%	

* Based on announced rate reductions.

** Rate reflects the clawback of the Ontario tax saved because of the low corporate rate. The clawback is required when taxable income falls between \$400,000 and \$1,128,519.

Table 6 Combined federal/provincial personal tax rates

		Taxable income* (over \$71,190)	2005**
Alberta	\$71,190 – \$115,739		36.00%
	Over \$115,739		39.00%
British Columbia	\$71,190 – \$75,917		37.70%
	\$75,917 – \$92,185		39.70%
	\$92,185 – \$115,739		40.70%
Manitoba	Over \$115,739		43.70%
	\$71,190 – \$115,739		43.40%
New Brunswick	Over \$115,739		46.40%
	\$71,190 – \$106,427		42.52%
Newfoundland and Labrador	\$106,427 – \$115,739		43.84%
	Over \$115,739		46.84%
Nova Scotia	\$71,190 – \$115,739		45.64%
	Over \$115,739		48.64%
	\$71,190 – \$80,841		42.67%
Ontario	\$80,841 – \$93,000		44.34%
	\$93,000 – \$115,739		45.25%
	Over \$115,739		48.25%
Prince Edward Island	\$71,190 – \$115,739		43.41%
	Over \$115,739		46.41%
Québec	\$71,190 – \$115,739		44.37%
	Over \$115,739		47.37%
Saskatchewan	\$71,190 – \$115,739		45.71%
	Over \$115,739		48.22%
	\$71,190 – \$105,056		39.00%
	\$105,056 – 115,739		41.00%
	Over \$115,739		44.00%

* Thresholds reflect the basic personal tax credit.

** 2006 rates have not been announced, but personal income tax rates are normally stable from year to year. In most provinces, thresholds are indexed.

PricewaterhouseCoopers Contacts

For further information, call or e-mail your PricewaterhouseCoopers adviser or any of the following:

Alberta			
Calgary	Kevin Hinz	403 509 7567	kevin.a.hinz@ca.pwc.com
Edmonton	Daniel Woodruff	780 441 6810	daniel.a.woodruff@ca.pwc.com
British Columbia			
Vancouver	Brad Sakich	604 806 7730	brad.a.sakich@ca.pwc.com
Manitoba			
Winnipeg	Serena Kraayeveld	204 926 2427	serena.h.kraayeveld@ca.pwc.com
New Brunswick			
Saint John	Dean Landry	506 653 9427	dean.landry@ca.pwc.com
Newfoundland and Labrador			
St. John's	Allison Saunders	709 722 3889	allison.j.saunders@ca.pwc.com
Nova Scotia			
Halifax	Elaine Sibson	902 491 7430	elaine.s.sibson@ca.pwc.com
Québec			
Montreal	Pierre Lessard	514 205 5034	pierre.lessard@ca.pwc.com
Québec City	Denis Girard	418 691 2437	denis.girard@ca.pwc.com
Ontario			
	Louis Provenzano	416 218 1563	louis.j.provenzano@ca.pwc.com
Greater Toronto Area	Jason Safar	905 972 4118	jason.safar @ca.pwc.com
	Ari Kurk	416 228 1021	ari.kurk @ca.pwc.com
	John Waters	416 365 8841	john.w.waters @ca.pwc.com
Kitchener/Waterloo	Jeff Jutzi	519 570 5708	jeff.k.jutzi@ca.pwc.com
London	Tom Mitchell	519 640 7916	tom.r.mitchell@ca.pwc.com
Ottawa	Kent Davison	613 755 4346	kent.davison@ca.pwc.com
Windsor	Debbie Meloche	519 985 8910	debbie.d.meloche@ca.pwc.com
Saskatchewan			
Saskatoon	Frank Baldry	306 668 5910	frank.m.baldry@ca.pwc.com