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INCORPORATING A CONSULTING BUSINESS

Why Incorporate?

There are a number of advantages to incorporating a consulting business, rather than operating as a sole proprietor:

1. Increased opportunities for income splitting with family members - income earned by the corporation may be paid out to persons other than the consultants by paying reasonable salary and/or dividends to family members.
2. Opportunities to save and defer tax - the corporation and individual are two separate taxpayers and are taxed at different rates (this is illustrated further in the Tax Rates section of this memo).
3. Opportunities to shelter capital gains on the sale of shares of the corporation - when selling shares of a "qualified small business corporation" (QSBC), it may be possible to use the enhanced capital gains exemption so that up to \$500,000 of the sale proceeds are not taxed. While the definition of a QSBC is quite stringent, in general the shares of a corporation providing consulting services should qualify as long as the corporation has not accumulated substantial non-active business/investment assets (each corporation must be reviewed in detail to determine this). If substantial non-active business assets have been accumulated there are methods available to "purify" the corporation so that it does qualify.
4. Limited liability - a corporation is a separate legal entity, only the assets of the corporation can be used to pay its creditors. If an unincorporated business runs into difficulties, paying off its debts could consume all the assets of its owners.

Tax Rates

The main benefits of incorporation for consultants are the potentials for both saving and deferring tax as a result of tax rate differentials.

Tax savings are experienced when dividends are paid to shareholders of the corporation with little or no other income and who could use the funds to pay for family lifestyle expenses. The amount of tax saved results from the spread between the lower and highest personal income tax rates. If a spouse or adult family member is a shareholder, directly or indirectly through a family trust, each person could receive approximately \$28,000 dividend in 2002 free of personal tax if they had no other source of income. This creates a tax saving of approximately \$7,000 per person, assuming the "consultant" taxable income is over \$60,000.

If the shareholders do not require all of the income produced by the business to support their family's lifestyle, cash may be kept in the business, invested and the second level of tax (personal) deferred until ultimate distribution. The amount of tax deferred depends on the difference between the corporate tax rate on income up to the corporation's small business limit and the individual's personal tax rate.

The tax rates for 2002 in Ontario are as follows:

Top personal income tax rate - 46.41%

Corporate tax rate up to the first \$200,000 of active business income - 19.12%

Relationship Between the Consultant and the Corporation

Consultants who are employees should not incorporate their employment income. The resulting corporation would likely be considered a "personal services business" and, as such, would be taxed at the highest tax rate. The potential tax advantages of incorporation only apply to those consultants who are currently considered self-employed. Canada Customs and Revenue Agency's guide RC4110, "Employee vs. Self-Employed," provides for this information, which we recommend you discuss with your accountant.

Once a consulting business has been incorporated, the role of the individual changes. Instead of being self-employed, the consultant is now an employee and also likely a shareholder and a director of the corporation.

Every corporation requires a Board of Directors. The shareholders of the corporation must appoint at least one director. The director does not have to be a shareholder. Directors may be personally liable for GST and payroll deductions collected by the company and not remitted to the Canada Customs and Revenue Agency (CCRA), for environmental damage caused by the company, etc. Directors are required to demonstrate that they have done their best to prevent the unpaid amounts for occurring; simple ignorance of the events is not a sufficient defense.

It is often advisable for the spouse who is the director to limit their ownership of family assets. We do not recommend both spouses being directors. You should discuss this with your professional advisor.

Anyone can be a shareholder of the corporation. All shares must be purchased at their fair market value in order to avoid adverse tax consequences. A shareholder's liability to the corporation's creditors is limited to their share capital.

Shares of the corporation may be purchased, and held, directly by family members or they may be owned indirectly through the use of a family trust. Please note that as a result of the recently implemented tax on split income (also termed the "kiddie tax") a private corporation should generally not pay dividends on shares owned by minors as this income will be taxed at the highest tax rate.

The use of a family trust to own the shares provides several advantages. We have a separate handout to explain the use of a family trust to own a business. The use of the family trust should be discussed with your professional advisor.

Initial Decisions Regarding Incorporation

1. Share Structure

The selection of an appropriate share structure for the corporation can only be made after the consultant's income and other objectives have been identified. The structure is depending on the income splitting strategies to be used (spouse, children, family trust), anticipated future use of the capital gains exemption, creditor-proofing issues, optimizing the small business deduction, which legislation the business was incorporated under, etc.

A corporation may have many different classes of shares with each class having different voting rights, dividend entitlements, rank in the event of dissolution, redemption rights, etc.

2. Where to Incorporate

A business may be incorporated under the Canada Business Corporations Act or one of the provincial corporation acts. Generally, a business has more flexibility if it is incorporated federally; however, the costs and advantages of incorporating in the different jurisdictions will need to be discussed with your lawyer.

3. Corporate Name

Corporations are assigned a number that it can use as its name, or one can choose to use a proper name.

Once a consulting business is incorporated, it is critical to ensure that all aspects of the business are conducted through, and in the name of, the corporation and not the individual. This is important to establish the separate existence of the. A failure to adhere to the legal form and substance of the arrangement may lead to a finding that the corporation is carrying on the practice as an agent for the individual. This may result in the business income earned by the corporation being taxed in the individual's hands. The clients of the consultant, and the general public, must be aware that the corporation, not the individual, is conducting the business.

4. Timing of Incorporation

If a brand new business is being started and incorporation is being planned, you should consider undertaking the business should be undertaken inside the corporation from the very beginning.

If the consulting business has already been established (either as a sole proprietorship or as a partnership), as part of the incorporation process the assets of the business will need to be transferred to the corporation.

A sole proprietor who transfers their practice to a corporation in mid-year will have a deemed year end upon the cessation of the business (at the transfer date) and will not be able to claim capital cost allowance in that year, as they will no longer own any assets. If the capital cost allowance claim is significant, consideration should be given to incorporating immediately after the end of the proprietor's normal fiscal period.

For consultants in partnerships who are transferring their practice to a corporation, care must be taken to time the transfer so that no adverse consequences arise from a negative equity position at the transfer date.

5. Choice of Year End

A new corporation must pick a year-end within 53 weeks from the date of incorporation. There are many factors to consider when selecting a year-end date, including the ability to defer income (bonuses) to shareholders/employees, the business cycle of the corporation and minimizing administration costs.

Mechanics of Incorporation

1. From a Sole Proprietorship

Sole proprietors should be able to transfer all of the assets of their proprietorship to the corporation on a tax-deferred basis. The corporation will receive the assets at their tax basis to the proprietor. In return, the proprietor may receive a promissory note, or have the corporation assume the sole proprietorship's liabilities, equal to the tax basis of the assets transferred. Any liabilities in excess of this amount should either remain with the individual personally or be exchanged for a promissory note payable to the corporation by the individual. If the corporation assumes additional debt, the asset transfer will not take place on a tax-deferred basis.

If any work-in-process exists, even if it is usually deferred for tax purposes, it must be included as one of the assets transferred to the corporation (with a tax basis of \$nil). Another asset to be considered in the transfer is goodwill. Goodwill usually has a \$nil tax basis but, if the individual made a February 22, 1994 capital gains election or paid for the goodwill, it may have a higher transfer price which can be withdrawn tax-free from the corporation.

A legal agreement for the purchase and sale between the individual and the corporation will be required for the transfers. This agreement will detail the property to be sold and the combination of shares, assumed liabilities and debt taken back as consideration. In order to determine the fair market value of the practice, it may be necessary to have a valuation of the practice.

2. From a Partnership

A tax deferred transfer of assets from a partnership to a corporation is also possible, although more complicated both from a tax and legal perspective.

The method of the transfer will depend on the desired ending business structure. The partnership may be transferred to one corporation owned by all of the former partners or each partner may form their own corporation and the corporations form a partnership. The rollover of partnership interests into individual corporations would allow each partner to have more flexibility. Every partner would not be required to incorporate under such a scenario.

The above comments regarding debt assumption, work-in-process and goodwill in the context of a sole proprietor also apply in the partnership situation. In the partnership scenario, there is also the potential for a negative partnership equity position. Generally, negative partnership positions should be eliminated prior to the transfers as, if they are not, the partner will realize a capital gain in the year of the transfer. Depending on the particular tax circumstances of the individual, however, this capital gain result may be desirable, either because of the current lower capital gains tax rates or because the partner has unused capital losses.

3. Goods and Services Tax (GST)

Depending on whether or not the entire business is being transferred to the corporation, what type of assets are being transferred and whether or not the individual and the corporation are registered for GST purposes, GST may be payable on the transfer of assets to the corporation. In most instances, a joint election may be filed by the vendor and the purchaser so that no GST will be payable on the supply of the business assets.

Other Issues to Consider

1. Small Business Deduction

The Small Business Deduction is available to Canadian-controlled private corporations on the first \$200,000 of "active business income". Please note that this small business limit is increasing in both the federal and provincial jurisdictions (albeit at different rates and levels), and it is anticipated that by 2005 lower rates of tax will be available on active business income up to \$400,000.

Income earned by a corporation from a consulting practice should qualify as active business income. This means that, as long as the corporation is a Canadian Controlled Private Corporation, its first \$200,000 of active business income may be taxed at the lower tax rate.

If a corporation is a member of a partnership that conducts an active business, each corporation's entitlement to the small business deduction is limited to its proportionate share of the partnership income. For example: if there were previously four physicians operating as equal partners in a medical partnership and now there are four corporate partners in the partnership, each corporation will be entitled to ¼ of the Small Business Deduction of \$200,000, or \$50,000.

The corporation will also have to share the small business deduction with other corporations that it is associated with. Corporations are associated if they have common ownership and control. There are a number of complicated rules in the Income Tax Act that determine whether or not corporations are considered to be associated. For example: A management corporation owned by a family trust may be associated with the corporation due to a rule that deems shares beneficially owned for children to be owned by the parents.

Each individual will need to review what other corporate shareholdings they and their family members own.

2. Goods and Services Tax (GST)

Just as for unincorporated businesses, the GST will need to be charged by most corporations on the consulting services provided. Businesses with less than \$30,000 of sales are not required to register (no tax charged on sales and no input tax credits permitted for GST incurred).

If a corporation has sales of less than \$200,000, they may be eligible to elect to use the Quick Method. The corporation would charge 7% GST but only remit to the CCRA 4% on the first \$30,000 of sales and 5% on the remainder. The business is not eligible for input tax credits except on capital asset purchases. This option is beneficial when corporations have business expenses with little or no GST paid on them (ex. salaries).

3. Extracting Funds from the Corporation

There are a number of possible ways to extract funds from the corporation:

- a) The promissory notes payable to the individual, in exchange for the tax basis of the assets transferred in, may be withdrawn from the corporation as a tax-free reduction of the note.
- b) The consultant may be paid a salary from the corporation. In determining the salary to be paid

consideration should be given to utilizing low personal tax brackets, creating RRSP contribution room, CPP contributions, Ontario Employer Health Tax, the timing of payroll remittances vs. personal quarterly instalments and the small business deduction available to the corporation.

- c) Reasonable salaries may be paid to family members for work performed in business (no different than when unincorporated).
- d) Income may be left and taxed in the corporation. Later, when the funds are required they may be withdrawn from the corporation as a taxable dividend to the shareholder. The combined corporate and personal tax will approximately equal the tax that would have been paid by the individual if the income had been earned directly. There is a benefit from the deferral of the second level of tax until the dividend is paid.

Generally, if the income of the corporation is below the small business limit, the consultant will only extract enough salary to utilize his or her low personal tax bracket. If the income of the corporation is above the small business limit, all of the excess income should be withdrawn as salary.

4. Payroll Remittances

As an employee, the individual will receive a salary that is subject to withholdings for income tax, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) contributions.

Payroll remittances will need to be made by the corporation at least monthly (the exact timing depends on the size and frequency of the payroll) and include the income taxes withheld on salaries paid and both the employer and employee portions of any CPP and EI amounts. Please note that there is no EI payable on salaries paid to shareholders owning more than 40% of the shares of a corporation (also no EI on salaries paid to the spouses of these shareholders).

While Ontario Employer Health Tax is no longer payable by self-employed individuals, it is still payable by corporations if the total salaries paid in a year exceed \$400,000.

5. Automobiles and Home Offices

If the consultant is required to use an automobile in carrying out their duties as an employee of the corporation, generally, the corporation should not purchase the automobile. In most circumstances, it will be more beneficial for the employee to own their

own car and receive an allowance from the corporation. A "reasonable" allowance (based solely on business kilometers driven and reimbursement of expenses such as parking) received by the employee, is not included in income. A calculation should be done to determine who should purchase the automobile.

To the extent that the employee's/shareholder's home is used either as the corporation's principal place of business or on a regular and continuous basis for meeting clients, the corporation may reimburse the employee/shareholder for a portion of their home expenses.

6. Employee Benefits

As a director, the consultant will have to consider which benefits the corporation will make available to its employee(s).

Benefits provided by the corporation to its employees that are taxable to the employee, are less expensive to the employee than if the employee incurred the expense themselves with after tax dollars.

Amounts paid by the corporation for a medical benefits plan for employees are not considered to be a taxable benefit to the employees. Premiums for the employees' short-term disability plan, if paid by the corporation, are also not considered a taxable benefit.

Long-term disability premiums should be included in the employees' taxable income so that any payments received under the plan are not taxable to them.

7. Income Tax Instalments

Both federal and provincial corporate instalments are payable monthly. Ontario has quarterly instalments, if the total is under \$10,000. No installments are payable during the corporation's first fiscal year.

8. Costs of Incorporation and Reporting Requirements

There are legal and regulatory costs to incorporate the company. There are also annual costs associated with maintaining the corporate minute books, preparing the company's annual financial statements and preparing the corporate tax returns (both federal and provincial).

9. December 31, 1995 Reserves

Individuals who carried on consulting practices as proprietors, or partners, prior to 1995 were allowed to bring "December 31, 1995 income" into taxable income over a ten-year period by claiming a reserve. This reserve was necessary when federal legislation effectively forced all sole proprietors and professional partnerships to switch to a calendar year for tax purposes. In order to continue to be eligible to claim the reserve the individual is required to carry on a business in the year; therefore, the reserve will be lost in the year following the year in which the consulting practice is transferred to a corporation.

While the loss of the reserve is a serious concern to many individuals, there may be ways to structure other income sources so that the business is continued (and thus the reserve maintained). As well, depending on the cash flow requirements of the individual and the year-end chosen for the corporation, it may be possible to defer taking a salary from the corporation until the taxation year after the remaining "December 31, 1995 income" has recognized for tax purposes.

Consultants should consider and review the potential benefits of incorporation with their professional advisors.

Website documents/IncorpConsultingBusiness.doc

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CONSULTANT INCORPORATION CHECKLIST

1. Are you an employee or self-employed? _____

2. Jurisdiction to incorporate:
– Federal or Provincial _____

3. Proposed Name of Corporation

- i _____
- ii _____
- iii _____

4. Share structure:

- Common shares
- Other shares and rights

- i _____
- ii _____

5. Proposed shareholders:

	<i>NAME</i>	<i>RELATIONSHIP</i>	<i>AGE</i>
1.	_____	_____	_____
2.	_____	_____	_____
3.	_____	_____	_____

6. Fiscal year end: _____

7. Other issues: