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INCORPORATION OF PROFESSIONALS IN ONTARIO

Background and Status of the Legislation

The 2000 Ontario Budget proposed implementing changes to various provincial regulations and acts so that individuals practicing in regulated professions in Ontario would be permitted to operate their businesses through a corporation. On November 1, 2001, the relevant provisions of Bills 152 and 45 were proclaimed and came into force. As well, in February 2002 the Ministry of Health and Long-Term Care released the regulations required to allow members of the Regulated Health Professions to incorporate. Accordingly, providing that the governing act of the regulated profession expressly permits it, incorporation of certain professionals is now permitted in Ontario.

Status of Particular Professional Bodies

The professions, which may be allowed to carry on their profession through a corporation, are listed below, along with a description of where in the process the particular profession's governing body is (as at March 10, 2003), in changing their bylaws and regulations so that their members may incorporate.

1. Members of the Regulated Health Professions:
 - a) Physicians and Surgeons - The College of Physicians and Surgeons of Ontario passed the necessary by-laws to allow its members to incorporate at its September 2002 Council meeting. The College has said that it will be in a position to start issuing Certificates of Authorization on November 18, 2002.
 - b) Dentists - The Royal College of Dental Surgeons of Ontario approved the by-laws necessary to allow its members to incorporate on August 28, 2002.

- c) Chiropractors - The College of Chiropractors of Ontario approved and passed the By-law 15, allowing its members to incorporate, on November 30, 2002.
2. Lawyers - The Law Society of Upper Canada has amended its by-laws to allow for professional corporations.
3. Veterinarians - The College of Veterinarians of Ontario amended the Regulations of the Veterinarians Act at the end of 2001 to allow for professional corporations.
4. Certified General Accountants - The Certified General Accountants Association of Ontario have amended their by-laws to permit the incorporation of professional practices.
5. Chartered Accountants - The by-laws and rules of the Institute of Chartered Accountants of Ontario have been amended to permit chartered accountants to form professional corporations.
6. Social Workers and Social Service Workers - The Ontario College of Social Workers and Social Service Workers has begun working on drafting the necessary amendments to their by-laws and was unable to provide a projected completion date for this project.

Details of the Legislation (Ontario Business Corporations Act)

1. Liability

Professional liability will not be limited in any way by practicing within a professional corporation. A corporation, however, may limit liability with respect to ordinary creditors.

2. Shareholder and Director Restrictions

Only one or more members of the same profession may own any and all of the issued and outstanding shares of the corporation (directly or indirectly). As a result, holding companies, family trusts, etc. cannot be used in the corporate structure, which will limit the opportunities for income splitting.

Also, all officers and directors of the corporation must be shareholders of the corporation. This ensures that only practicing professionals will make decisions on behalf of the professional corporation.

3. Permitted Business

The corporation may not carry on a business other than the practice of the profession; however, they may carry on activities related to or ancillary to the practice of the profession, including the investment of surplus funds earned by the corporation.

4. Corporate Name

The name of the corporation must include the words "Professional Corporation" or "Société professionnelle." The corporation may not be a numbered corporation. As well, the name must comply with the rules respecting names as set out in the regulations, rules or by-laws governing the profession.

5. Authorization

In order to legally practice, the professional corporation must have authorization to do so from their profession's governing body. This authorization will take the form of a certificate of authorization (or similarly named document) and will be issued by the regulatory body to the approved professional corporation.

The Methods & 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 professional personally or be exchanged for a promissory note payable to the corporation by the professional. 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 professional 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 professional 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 transfer 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 professional corporations allows each partner to have more flexibility; including the flexibility to not incorporate in 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. Employees

Professionals 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 bracket. The potential tax advantages of incorporation will only apply to those professionals who are currently considered self-employed.

Issues to Consider When Deciding If and When to Incorporate

1. December 31, 1995 Reserves

Individuals who carried on professional 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 professional 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.

2. Small Business Deduction

The Small Business Deduction is available to Canadian-controlled private corporations on the first \$225,000 (\$200,000 in 2002) 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 professional practice should qualify as active business income. This means that, as long as the professional corporation is a Canadian Controlled Private Corporation, its first \$225,000 of active business income may be taxed at a lower tax rate (approximately 18.62% in Ontario for 2003).

If a professional 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 \$225,000, or \$56,250.

The professional 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 professional corporation due to a rule that deems shares beneficially owned for children to be owned by the parents.

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

The main benefit of incorporation for professionals is the deferral of tax arising from the tax rate differential (the corporate tax rate on income up to the corporation's small business limit vs. the personal tax rate). If the professional does not require all of the income produced by their practice to support their personal lifestyle, some of the income produced by the practice could be held by the corporation, invested and the second level of tax (personal) deferred until ultimate distribution. To the extent that no equity will accumulate in the business, the tax deferral benefits of incorporation are greatly reduced.

3. Timing of Incorporation

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 professionals 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.

4. Goods and Services Tax (GST)

Depending on whether or not the entire practice is being transferred to the corporation, what type of assets are being transferred and whether or not the professional (or partnership) 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.

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. Please note, if a professional corporation is a member of a partnership, they will be forced (by the Income Tax Act) to have a December 31 year-end.

6. Extracting Funds from the Professional Corporation

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

- a) The promissory notes given to the professional, 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 professional 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 professional 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 professional 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.

Please note that management fees should generally not be used to extract funds from the corporation, as they will be subject to GST, which will not qualify as an input tax credit to the corporation in the case of the regulated health professions.

7. Small Business Capital Gains Deduction

When shares of a "qualified small business corporation" are sold, it is possible to use the enhanced capital gains exemption so that up to \$500,000 of the sale proceeds are not taxed. In general the shares of a professional corporation will qualify as long as the corporation has not accumulated substantial non-active business 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.

8. Potential Opportunities for Tax Deferral

In the corporation, it may be possible for either statutory or non-statutory pension plans to be set up for the corporate employees (including the professional). This is not an option that is available to an unincorporated professional practice.

The estate of a deceased employee (for example, the professional) can receive a "death benefit" of up to \$10,000 from a corporation, free of tax.

9. Relationship Between the Professional and the Corporation

Once a professional practice has been incorporated, the role of the professional changes. Instead of being self-employed, the professional is now an employee, a shareholder and a director of the corporation.

As an employee, the professional 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.

If the professional is required to use an automobile in carrying out their duties as an employee of the corporation, 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.

If the professional is considering leasing an automobile, a cash flow calculation should be done to see if it is beneficial for the company to lease the car.

The 2003 Federal Budget proposed to lower the benefits for company automobiles, which should improve the overall cash flow position.

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.

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.

10. Income Tax Instalments

Both federal and provincial corporate instalments are payable monthly. None are payable during the corporation's first fiscal year.

11. 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).

12. Agency Issues

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

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

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