

INCORPORATION OF PROFESSIONALS IN ONTARIO

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Status of Particular Professional Bodies

The following professions have been allowed to carry on their profession through a corporation:

1. Members of the Regulated Health Professions:
 - a) Physicians and Surgeons - The College of Physicians and Surgeons of Ontario
 - b) Dentists - The Royal College of Dental Surgeons of Ontario
 - c) Chiropractors - The College of Chiropractors of Ontario
 - d) Chiropodists—The College of Chiropodists of Ontario
2. Certified General Accountants - The Certified General Accountants Association of Ontario
3. Chartered Accountants - The Institute of Chartered Accountants of Ontario
4. Lawyers - The Law Society of Upper Canada
5. Social Workers and Social Service Workers - The Ontario College of Social Workers and Social Service Workers
6. Veterinarians - The College of Veterinarians of Ontario

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

Except for physicians, surgeons and dentists, 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).

All officers and directors of the corporation must be members of the profession. This ensures that only practicing professionals will make decisions on behalf of the professional corporation.



For all professionals, unfortunately in Ontario, unlike some other provinces, holding companies, family trusts, etc. cannot be used in the corporate structure, which will limit the opportunities for income splitting and asset protection.

The physicians and surgeons successfully lobbied the Ontario government to amend the Regulated Health Professionals Act to allow family members to own non-voting shares. Perhaps it was a trade off to provide extra tax savings versus a major overhaul to Ontario's medical fee payment structure. Dentists appear to have benefited, since they are included in the Regulated Health Professions Act.

Family members include the doctor's spouse, children, and parents.

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.

Other than for business purposes, the corporations should not borrow funds to purchase investments.

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. Small Business Deduction

The Small Business Deduction is available to Canadian-controlled private corporations on the first \$500,000 of "active business income."

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 \$500,000 of active business income, in Ontario, may be taxed at a lower tax rate of 16.5%, reducing to 15.5% after June 30, 2010.

There have been several Canada Revenue Agency tax rulings in the past two years, which, if properly structured, allows each member of a professional partnership to incorporate, become an employee of the professional corporation, and charge the professional partnership for his or her services. The result is each partner can access the \$500,000 active business lower tax rate.

It is important to speak to both your accountant and lawyer before you proceed to rearrange your partnership



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 is 16.5%/15.5% on income up to the corporation's small business limit vs. the personal tax rate – maximum 46.41%). If the professional does not require all of the income produced by their practice to support their personal lifestyle, some of the income 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.

The physicians, surgeons and dentists have the added benefit of income splitting, since their family members can be shareholders. Depending on their family members' other income, it could result in over \$12,000 of annual tax savings per family member, even if all the funds are taken from the professional corporation for personal family needs. Of course, proper planning must be done to maximize the benefits.

For transactions on July 1, 2010 and later, HST must be considered.

2. 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.

3. 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.

4. 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.

5. 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, generally 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 (HST after June 30, 2010), which will not qualify as an input tax credit to the corporation in the case of the regulated health professions.

6. 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 \$750,000 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).

In many cases, the goal is to use the tax deferral of 29.9% (30.9% after June 30, 2010) and related income for long-term investments within the corporation. In this case, the corporation most likely will not qualify for the \$750,000 capital gains exemption.

Until the legislation in all professions is changed to allow a corporate shareholder, the only way to make the company qualify for the capital gains exemption is to pay taxable dividends to the shareholder to meet the required asset holding test.

You should discuss the \$750,000 capital gain exemption provision with your accountant prior to proceeding.

7. 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.

8. 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

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 kilometres 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.

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.

9. Income Tax Instalments

Corporate income tax instalments are payable monthly; however, instalments are not payable during the corporation's first fiscal year.

10. 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.

11. 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.

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