

Tax Memo

Professional Corporations— An Attractive Option

Recent and planned corporate income tax rate reductions mean that now is a good time for eligible professionals to consider incorporating their practices. The low corporate tax rate (available on \$500,000 of corporate income federally and in most provinces), flexibility in respect of remuneration and access to the \$750,000 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 key 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 the individuals listed on www.pwc.com/ca/hnwtaxcontacts.

Contents

Professionals Who May Incorporate.....	1	Other Considerations	4
Restrictions.....	1	Summary.....	6
Tax Advantages	2	Appendix: Income Tax Rate Tables	7

Professionals Who May Incorporate

Typically, only those professions that by law are governed by a professional body or association 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. Individuals should check with their governing body to determine whether these restrictions apply to them. In Ontario, family members may now be shareholders in certain professional corporations, including 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.

Corporate income subject to low rate

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. As shown in **Table 1** (page 3), in 2009, up to \$500,000 of income is subject to low corporate rates in many provinces. This advantage will be optimized if \$500,000 (lower in some provinces) 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.

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 \$500,000 (lower in some provinces) of annual corporate income, but not for corporate income exceeding this threshold.

Deferring tax

In general, the opportunity to defer tax arises because corporate tax rates on professional income up to \$500,000 are substantially lower than personal tax rates. This is illustrated in the **Appendix**, which provides combined federal/provincial corporate income tax rates on professional income and combined federal/provincial marginal personal income tax rates.

As noted above, the greatest advantage of a professional corporation is the ability to defer tax by retaining \$500,000 (lower in some provinces) of professional income annually in the corporation. That income will be subject to a special low rate, which for years ending December 31, 2009 is as low as 13.37%, as shown in the **Appendix**.

Table 1 shows the income tax deferral if active business income that is subject to the low corporate income tax rate 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 Quebec) if the after-tax corporate income is paid out as a dividend to the shareholder.

Table 1 Professional income earned using a corporation vs. directly (2009 and 2010)

		Amount of income	Deferral	Saving (Cost)
2009 ¹	Alberta	\$490,137 ²	\$122,534	\$5,738
	British Columbia	\$400,000	\$120,800	\$7,629
	Manitoba		\$137,600	\$3,107
	New Brunswick	\$500,000	\$150,000	\$6,325
	Newfoundland and Labrador		\$142,500	\$5,125
	Nova Scotia	\$400,000	\$129,000	\$17,924
	Ontario	\$500,000	\$149,548	\$18,696
	Prince Edward Island		\$169,994	\$4,768
	Quebec	\$478,630 ³	\$139,832	(\$1,101)
	Saskatchewan	\$500,000	\$142,500	\$12,229
2010 ¹	Alberta	\$500,000	\$125,000	\$5,854
	British Columbia ⁴		\$151,000	\$5,211
	Manitoba	\$400,000	\$137,940	\$3,317
	New Brunswick	\$500,000	\$136,500	\$7,000
	Newfoundland and Labrador		\$142,500	\$5,125
	Nova Scotia	\$400,000	\$129,000	\$17,924
	Ontario	\$500,000	\$152,069	\$15,267
	Prince Edward Island		\$175,494	\$1,535
	Quebec	\$478,630	\$146,075	(\$1,151)
	Saskatchewan	\$500,000	\$142,500	\$12,229

- The figures assume the individual pays tax at the top combined federal/provincial income tax rate. Other levies (e.g., Canada Pension Plan or Quebec Pension Plan) are ignored.
- Alberta's threshold increased from \$460,000 to \$500,000 on April 1, 2009. The pro-rated threshold for years ending December 31, 2009, is \$490,137.
- Quebec's threshold increased from \$400,000 to \$500,000 on March 20, 2009. The pro-rated threshold for years ending December 31, 2009, is \$478,630.
- British Columbia's threshold will increase from \$400,000 to \$500,000 on January 1, 2010.

For example, in 2009, an individual taxed at Prince Edward Island's top personal tax rate can defer \$169,994 of tax by retaining \$500,000 of income in a corporation. When the income is paid out of the corporation as a dividend, the ultimate tax saving is \$4,768. The deferral is \$175,494 in 2010, and may be even higher in future years because Prince Edward Island's low corporate rate will decrease on April 1, 2010.

Access to special low rate: cautions

Caution is advised when assessing the possible benefit from the special low corporate rate on the first \$500,000

(lower in some provinces) 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 \$500,000 (lower in some provinces) 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 tax rate is limited if the corporation has associated corporations, because associated companies must share the \$500,000 (lower in some provinces) 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 \$500,000 (lower in some provinces) threshold. In other words, the partnership is entitled to only one 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 that income. These restrictions may apply if a professional provides employment services, as opposed to professional services, through a corporation.

Specified investment business

The special low rate does not apply 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 not subject to low rate

If more than \$500,000 (lower in some provinces) 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 may 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 \$500,000 (lower in some provinces) 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 \$500,000 (lower in some provinces) 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.

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 \$500,000 (lower in some provinces), i.e., all income not subject to the low corporate tax rate, should be paid as salary or bonus (see **Corporate income not subject to low rate** on this page). 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 Quebec Pension Plan contributions (see **Canada Pension Plan/Quebec 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 \$750,000 capital gains exemption** below).

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.

Access to \$750,000 capital gains exemption

The \$750,000 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).

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 2009 Payroll Tax

	N/A if payroll under ¹	Maximum rate
Manitoba	\$1,250,000	2.15%
Newfoundland and Labrador	\$1,000,000	2%
Ontario	\$400,000	1.95%
Quebec²	No exemption	4.26%

1. Associated or related corporations may be required to share the exemption.
2. Quebec 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 \$732 (\$584 in Quebec) and the maximum employer contribution of \$1,025 (\$817 in Quebec) are required for 2009 when the employee's earnings are at least \$42,300.

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

For 2009, when the earnings of an employee or a self-employed individual are at least \$46,300, the following rules apply.

Table 3 2009 CPP/QPP

		Amounts
Employee	Employer contribution	
	Employee contribution	\$2,118.60
	Deductible to employer	
	Eligible for employee tax credit	
Self-employed	Self-employed contribution	\$4,237.20
	Deductible	\$2,118.60
	Eligible for tax credit	

Other Quebec contributions

In Quebec, individuals whose income from certain sources is \$13,075 (in 2009) must contribute a maximum of \$1,000 annually to Quebec's Health Services Fund. The contribution is imposed on both professional income and dividends, but not on remuneration. It does not give rise to a credit because the credit is included in Quebec's basic personal credit.

In addition, employees, employers and the self-employed must contribute to the Quebec Parental Insurance Plan (QPIP). For 2009, when the earnings of an employee or a self-employed individual are at least \$62,000, the following QPIP rules apply.

Table 4 2009 Quebec Parental Insurance Plan (QPIP)

		Federal	Quebec
Employee	Employer contribution	Nil	\$419.74
	Employee contribution		\$300.08
	Deductible to employer		\$419.74
	Eligible for employee tax credit	\$300.08	Nil ¹
Self-employed	Self-employed contribution	Nil	\$533.20
	Deductible		\$233.12
	Eligible for tax credit	\$300.08	Nil ¹

1. For Quebec purposes, the amount of the credit is nil because the credit is included in Quebec's basic personal credit.

Workers' compensation

Contributions to provincial workers' compensation plans are based on the employer's annual payroll and are deductible for tax purposes. Premium rates are based on the accident experience of the particular industry and activity. Certain businesses and industries are not required to remit workers' compensation premiums.

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. 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 that 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 provincial capital tax in Manitoba, Nova Scotia, Ontario and Quebec on their taxable capital employed in the province. However, because most professional corporations will have taxable capital below the provincial capital tax exemptions, capital taxes generally will not be a concern. In any case, provincial capital taxes will be entirely phased out by July 1, 2012.

Capital tax rates and exemptions for December 31, 2009 year ends are as shown below.

Table 5 2009 Capital tax

	Rate	Exemption ¹
Manitoba	0.2%, 2.4% or 0.4%	\$10 million
Nova Scotia	0.35% or 0.175%	Up to \$5 million
Ontario	0.225%	\$15 million
Quebec	0.24%	Up to \$1 million

1. Exemptions are generally shared by associated or related corporations.

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. Before you proceed, contact your PricewaterhouseCoopers adviser or any of the individuals on www.pwc.com/ca/hnwtaxcontacts for an evaluation.

Appendix: Income Tax Rate Tables

Table 6 Combined federal/provincial corporate tax rates on professional income (December 31 year ends)

		2009	2010
Alberta	First \$460,000	14%	
	\$460,000 – \$500,000	15.73%	14%
	Over \$500,000	29%	28%
British Columbia	First \$400,000	13.5%	
	\$400,000 – \$500,000	22%	13.5%
	Over \$500,000	30%	28.5%
Manitoba	First \$400,000	12%	11.92%
	\$400,000 – \$500,000	23.5%	23%
	Over \$500,000	31.5%	30%
New Brunswick	First \$500,000	16%	
	Over \$500,000	31.5%	29.5%
Newfoundland and Labrador	First \$500,000	16%	
	Over \$500,000	33%	32%
Nova Scotia	First \$400,000	16%	
	\$400,000 – \$500,000	27%	
	Over \$500,000	35%	34%
Ontario	First \$500,000	16.5%	16%
	\$500,000 – \$1,500,000	37.25% ¹	33.1% ¹
Prince Edward Island	Over \$1,500,000	33%	30.99%
	First \$500,000	13.37%	12.27%
Quebec	Over \$500,000	35%	34%
	First \$400,000	19%	
Saskatchewan	\$400,000 – \$500,000	19.83%	19%
	Over \$500,000	30.9%	29.9%
Saskatchewan	First \$500,000	15.5%	
	Over \$500,000	31%	30%

1. Rate reflects the clawback of the Ontario tax saved because of the low corporate rate. The clawback is required when taxable income falls between \$500,000 and \$1,500,000. It will be eliminated commencing July 1, 2010.

Table 7 Combined federal/provincial personal tax rates

	Taxable income ¹ (over \$81,452)	2009 ²
Alberta	\$81,452 – \$126,264	36%
	Over \$126,264	39%
British Columbia	\$81,452 – \$82,014	36.5%
	\$82,014 – \$99,588	38.29%
	\$99,588 – \$126,264	40.7%
Manitoba	Over \$126,264	43.7%
	\$81,452 – \$126,264	43.4%
	Over \$126,264	46.4%
New Brunswick	\$81,452 – \$116,105	42%
	\$116,105 – \$126,264	43%
Newfoundland and Labrador	Over \$126,264	46%
	\$81,452 – \$126,264	41.5%
	Over \$126,264	44.5%
Nova Scotia	\$81,452 – \$93,000	44.34%
	\$93,000 – \$126,264	45.25%
	Over \$126,264	48.25%
Ontario	\$81,452 – \$126,264	43.41%
	Over \$126,264	46.41%
Prince Edward Island	\$81,452 – \$98,143	42.7%
	\$98,143 – \$126,264	44.37%
Quebec	Over – \$126,264	47.37%
	\$81,452 – \$126,264	45.71%
Saskatchewan	Over \$126,264	48.22%
	\$81,452 – \$114,610	39%
	\$114,610 – \$126,264	41%
	Over \$126,264	44%

1. Thresholds reflect the federal and provincial basic personal tax credits.
2. Most 2010 rates have not been announced, but personal income tax rates are normally stable from year to year. In most provinces, thresholds are indexed.

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