



The Professional's Option – Professional Incorporation

Many professionals now have the opportunity to run their business as a professional corporation. The ability to incorporate raises a number of planning issues and opportunities. This Tax Topic will explore the ins and outs of professional incorporation.

Who can incorporate?

Traditionally, professionals have carried out their practices as either sole proprietors or in partnerships. While there are many positive tax and non-tax reasons for carrying on a business in one of these business structures, tax planning may be more limited. (See the Tax Topics on Business Structures for a more in depth discussion on these forms of business) As a result, professionals have lobbied provincial governments across the country for the ability to incorporate their practices. The provinces and territories have enacted legislation to permit certain professions to carry on their business activities through a professional corporation. Professionals can incorporate in all provinces and territories but in some jurisdictions this right is limited to only a few professionals. For a comparison of who may incorporate in the various provinces see Appendix "A".

General considerations

A professional corporation is like any other corporation. The difference is that it is subject to certain rules. Many of the planning opportunities that occur in a corporate setting will apply in the same manner to a professional corporation. In the event a professional corporation loses its status as a professional corporation, it still remains a corporation.

Legal implications

One of the key reasons for incorporating a business is the ability to limit liability. A corporation is an entity separate and distinct from its shareholders. It is the corporation that owns and operates the business and has any liability. This is in contrast to partnerships and sole proprietorships. A sole proprietor and partners of a partnership are liable to the full extent of their personal assets for the liabilities of their business. In contrast, a shareholder's liability to creditors of the corporation is limited to the amount of his or her investment. (For a further look at business structures see the Tax Topic "Business Structures").

For professionals, the ability to limit liability is curtailed. With the exception of architects and engineers, other professions cannot limit shareholder liability for negligence and malpractice. Professional liability is imposed under the governing provincial statute with respect to acts carried on by the shareholders and employees or agents of the professional corporation. Therefore shareholders of a professional corporation will continue to be jointly and severally liable. The governing body of each professional organization determines what limitations may exist in terms of liability. While this is a drawback, a professional corporation can limit liability in respect of other forms of liability such as financing obligations, leases, non-guaranteed bank

loans, and non-professional contingencies to the extent that the professional has not personally guaranteed payment.

Considerations when incorporating

There are legal set-up costs and on-going costs that must be considered when incorporating. These costs apply in the professional corporation context as well. Annual financial statements must be prepared each year, permits must be renewed in relation to the incorporation, T2 corporate tax returns must be prepared and payroll tax and capital tax must be paid. All of these costs may outweigh any tax savings.

Cash flow needs also play a factor in whether a professional incorporation makes sense. If all the professional profits are going to flow out to shareholders to support personal cash flow needs, incorporation is probably not the best solution. Current federal and provincial tax rates will also have a bearing on whether a professional should consider incorporating. The other considerations are whether an individual practices on their own, with a small group of partners or in a large partnership which may operate in more than one province. Depending on the size, nature and location of the business it simply may not make sense to incorporate. For instance, incorporation may increase or decrease the amount of taxes paid depending upon the province where the business ordinarily operates. An individual member of a partnership would pay tax on a portion of the income in each applicable province. In the context of a professional corporation, personal tax is payable on salary and/or dividends received from the professional corporation, based on the individual's province of residence. This may be advantageous if the marginal tax rate in that particular province is lower than the multi-jurisdictional rates that would have otherwise applied to the partnership income.

Ownership, restrictions and structures

Under most provincial legislation, the professional corporation may not carry on a business other than the practice of the profession. Also, the professional governing body may have other types of restrictions that may be imposed. For example, a professional corporation may not operate under a numbered company and the words "Professional Corporation" may need to be present in the name of the professional corporation. Voting agreements in most instances are void if they remove voting rights from the professional shareholder; unanimous shareholder agreements are not permissible if not all of the shareholders are members of the same profession.

In many provinces (e.g. Alberta), members of the same profession must own all of the shares of the professional corporation (but see discussion below on income splitting). In many provinces, all officers and directors must be shareholders of the professional corporation. Generally, professional corporations can carry on activities related to or ancillary to the practice of the profession including the temporary investment of surplus funds. This means that succession planning is limited to the buy-out of other professionals if the business is to continue on as a professional corporation. In some instances, where death of a professional shareholder occurs shares may be rolled to a non-professional spouse or personal representative of the professional deceased shareholder's estate, which will not immediately affect the status of the professional corporation. However, provincial legislation limits the conditions under which such transfers or rollovers can occur and sets out time lines that must be adhered to in order to keep the professional corporation status. A common structure in the professional corporation setting is a 2-tier arrangement where the individual's professional corporation owns shares in an operating company (professional corporation) or has an interest in a partnership.

A professional corporation may require certification by its professional governing body. Each governing body establishes its own certification process. Governing bodies may have the ability to look through the corporation to hold professional shareholders accountable to meet such requirements.

Tax Advantages

A professional corporation is generally treated like any other small business corporation. If income is earned through a professional corporation, the income will be taxed at the corporate

level and then again at the personal level when the corporation distributes its after-tax income to a shareholder in the form of a dividend or salary. (For a detailed discussion of corporate taxation refer to the Tax Topic entitled "Corporate Taxation".)

a) Tax Deferral

One of the greatest advantages of incorporation is the ability to defer tax by retaining income in the corporation. This income is subject to corporate tax rates, which is usually lower than the professional's personal tax rates. This deferral is currently the greatest in relation to income eligible for the small business deduction (discussed in more detail below).

Because the corporate tax rate on income eligible for the small business deduction is significantly lower than the personal tax rate, there is a significant deferral of tax until the time the income is ultimately distributed to the shareholder. There should also be no additional tax cost if income is taxed in the corporation at the small business rate and then flowed out to the shareholder as a dividend and taxed personally, compared to the income being paid out as salary and taxed by the shareholder personally (or if earned in a partnership or sole proprietorship).

Income taxed at the higher corporate tax rates may still provide some deferral of tax if the corporate tax rate is below the personal tax rate. However, in the past this generally resulted in an ultimate tax cost when this income is paid out of the company. That is, the total corporate and personal tax paid (when the income is paid out as a dividend) exceeded the tax that would have been paid had the income been earned personally. This was due to the fact that prior to 2006 there was only one dividend tax credit rate and one gross up rate. These rates were designed to offset corporate tax, but only to the extent it had been paid at the small business income rate, as a result integration failed when a corporation paid tax at the high rate. Accordingly it was common practice to reduce the corporation's income down to the small business limit by paying out any income in excess of the small business limit as salary to the professional. This is often referred to as "bonusing down". To correct this inequality the government introduced two types of dividends (eligible and ineligible) and two levels of dividend tax credits and gross up. For a detailed discussion of the integration theory behind the "bonusing down" strategy and the taxation of dividends refer to the "Integration" section of the Tax Topic "Corporate Taxation".

If the professional draws all of the income out of his professional corporation to provide for personal cash flow needs, this tax deferral advantage is eliminated.

b) Small business deduction

A Canadian-controlled private corporation (CCPC) that earns income from an active business carried on in Canada is generally entitled to a reduced tax rate on its annual income from an active business up to a certain income threshold referred to as the "annual business limit". (The federal annual business limit for 2008 is \$400,000. Some provincial thresholds are higher). This reduction in tax rate is accomplished by allowing the corporation to claim the "small business deduction".

There are different restrictions that exist which may affect whether, or to what extent, the benefits of the small business deduction will be available.

If a professional corporation has multiple shareholders, the corporation is only entitled to one \$400,000 small business deduction limit. Similarly, if a professional partnership has multiple corporate partners, it too will be entitled to only one small business deduction limit. Consequently, whenever possible, it is advisable for professionals to incorporate their own professional corporation rather than having multiple shareholders of a single professional corporation or multiple corporate partners of a single professional partnership. With separate professional corporations, provided that the corporations are not associated, each company (and therefore each professional) will be entitled to their own small business deduction limit.

If a professional corporation is associated with other companies, the small business deduction limit must be shared with those corporations. The association rules are quite complex and

include several deeming provisions. In general, a professional corporation will be associated with any other companies that the controlling shareholder controls as well as any company owned by shareholders who are related to the controlling shareholder of the professional corporation if the controlling shareholder of the professional corporation owns at least 25% of the shares of any class of that other company. Therefore, care must be taken to avoid the professional corporation being associated with any other corporations, or the available small business limit may be reduced.

In addition, the small business deduction will not be available on income from a "personal services business" or a "specified investment business". These are defined terms in the Act, and are discussed in detail in the Tax Topic "Corporate Taxation".

In general terms a professional corporation might be considered to be carrying on a "personal services business" if it were reasonable to regard the professional as an employee of their client(s) if the corporation did not exist.

A "specified investment business" is a business whose principal purpose is to derive income from property. Therefore, to the extent that funds in excess of those needed for operations are accumulated and invested in the professional corporation, the small business deduction will not be available on any income derived from these investments.

c) Capital gains exemption

For qualified small business corporation ("QSBC") shares, qualified farm property and qualified fishing property the capital gains exemption will be exempt from tax up to \$750,000 in capital gains. This exemption may be available to a professional corporation to reduce the tax arising on the sale of the shares of the professional corporation, or on the shareholder's death. In order for the shares to qualify for the exemption there are several complex tests that must be met with respect to the type of assets owned by the corporation and the length of the period during which the shares are held. (For a discussion of these rules see the Tax Topic "The \$750,000 Capital Gains Exemption"). As a result of these complex tests the professional may want to consider realizing a gain and utilizing the exemption at the time of incorporation. Such planning would increase the cost base of the shares and therefore potentially decrease future gains on the disposition of the shares. This process is often referred to as "crystallizing" the capital gains exemption.

The benefit of the exemption (or the crystallization) will depend on whether the professional corporation shares can be sold. A purchaser may have a preference to buy the assets of the corporation rather than shares due to potential liabilities associated with the corporation. In addition, before a plan to crystallize is implemented, consideration should be given to the potential costs and any implications for post mortem planning.

d) Fiscal year end and tax installments

Partnerships and sole proprietorships since 1995 must have a calendar year end for tax purposes. A professional corporation may choose a non-calendar year-end. This may work better in the business cycle; a shareholder/employee (i.e. owner-manager) can defer a bonus payment to the next calendar year by having the bonus paid later in the year so that the bonus payment may be taxed in the next calendar year. Corporations that are corporate partners however, do not have the ability to select a non-calendar year end.

Corporations can also defer tax in their first year, because installment payments do not have to be paid in the first year. Thereafter installment payments must be paid monthly. This is unlike partnerships or sole proprietors where tax installment payments must be made quarterly and cannot be deferred in the first year of business.

e) Remuneration flexibility and accruals

The incorporated professional has the ability to choose between salary and dividends. Before one is selected over another there are some general considerations that must be reviewed. Professionals may wish to receive sufficient income as salary to make a maximum contribution to a registered retirement savings plan (RRSP) and Canada Pension Plan or to the Quebec

Pension Plan. In the alternative, the payment of dividends may be preferred if the professional has a cumulative net investment loss (CNIL) and is seeking to claim the capital gains exemption.

The professional's tax liability may be deferred if the professional corporation accrues bonuses and/or employee profit sharing plan (EPSP) contributions. Special rules allow an employer to claim a deduction for accrued remuneration and EPSP contributions, while the employee is not taxed on these amounts until they are actually paid.

Planning opportunities

Professionals have a wider range of planning opportunities available to them as a result of being able to incorporate. There are various considerations that will allow for better planning solutions.

a) Probate planning

Many jurisdictions will allow for a second will to avoid probate on certain assets. A second will can be created dealing with the distribution of the assets that would not be the subject of an application for a probate grant. Shares in a professional corporation can be the property dealt with in a second will and where there would be no contest as to the distribution of those shares under the provisions of a will, probate will not be necessary.

While the Ontario Court of Appeal has permitted this type of planning (see **Estate of Philip Granovsky**, (1998) 156 D.L.R. (4th) 557, 53 O.T.C. 375, 21 E.T.R. (2d) 25) other jurisdictions do not allow it. The Probate Act of Nova Scotia does not permit the use of multiple wills nor is this type of planning permitted in Manitoba. For a professional living in a jurisdiction that does permit such planning, this provides a way to avoid probate fees related to their business interest.

b) Estate freeze

An estate freeze can be implemented if the professional holds common shares in the professional corporation. The professional can exchange these shares for newly issued preferred shares that are redeemable and retractable at a fixed amount (current fair market value) and that do not grow in value. The gain on the common shares that are exchanged may be realized at the time of the exchange allowing the professional shareholder to make use of the \$750,000 capital gains exemption or the gain may be deferred. This type of planning however is difficult as usually the common shares are issued to family members to allow for the growth in those shares to be passed on to the next generation. In the professional corporation setting, this type of planning can be limited in provinces where a non-professional is unable to hold shares in a professional corporation.

c) Income splitting

While income splitting has been significantly curtailed by the application of the attribution rules and the kiddie tax in the Income Tax Act, there still may be planning opportunities available in the professional corporation context. Whether non-professionals can be shareholders of a professional corporation will depend upon provincial legislation. In some jurisdictions, non-professionals can be shareholders of a professional corporation. For instance, in British Columbia, physicians, dentists, engineers, lawyers and accountants are able to issue non-voting shares of their professional corporation to immediate family members, holding companies and trusts. Regulations have passed in Ontario, which permit dentists and doctors to have non-voting family members as shareholders. In this instance, dividends can be paid to non-professional shareholders, which could result in significant overall family tax savings.

As stated above, Ontario has passed regulations that allow both doctors and dentists to allow non-voting family members as shareholders. However, both the College of Dental Surgeons and the College of Physicians and Surgeons have decided to disallow the use of holding companies as shareholders of a professional corporation in Ontario.

In provinces where non-professionals are unable to hold shares in a professional corporation, spouses and children of the professional may be able to hold shares, directly or indirectly, in a management company that provides services to the professional corporation. This allows another way for family members to engage in income splitting. However, care should be taken to ensure that the management company would not be considered to be associated with the professional corporation.

Alternatively, a trust could be utilized. For example, a trust could also be a partner of a managing partnership that provides services. A spouse and children could be beneficiaries of the trust.

Non-professionals may also be employees of the corporation and receive a reasonable salary. This would allow income splitting to occur amongst family members while employed by the corporation.

d) Buy-sell considerations

Buy-sell structures in the professional corporation context are done in the same manner as with any corporate buy-out. The difference arises as to who will ultimately hold the shares. If the surviving shareholders are all professionals and are purchasing the deceased professional's shares then the buy-out occurs pursuant to the structure agreed upon by the shareholders and the corporation continues on as a professional corporation. If however, the buy-out will result in a non-professional owning the shares, then the distinction becomes not so much in the actual buy-out structure but in the fact that the professional corporation will no longer be considered a professional corporation. In this scenario the professional corporation loses its status. For instance, a structure that contemplates shares rolling to a spouse and then being redeemed can still be utilized however the status of the corporation will no longer be a professional corporation unless the spouse is also a professional practicing in the same profession.

The same tax planning on buy-out can occur with a professional corporation as with any type of corporation. The outcome from a tax perspective for the individual shareholder and the surviving shareholders will be the same but for the consideration of the loss of status should a non-professional own the shares at death. This consideration may limit the structure options available to the professional and therefore limit their tax planning options. For a further discussion on buy-sell structures see the Tax Topic entitled "Buy-sell Agreements – An Overview of Funding with Life Insurance".

Insurance planning opportunities

Life insurance owned by a professional corporation allows cheaper after-tax dollars to be used to purchase the policy, which is not the case in the sole proprietorship or partnership context. This provides an opportunity to professionals that has not previously existed and therefore may entice professionals to consider life insurance in the planning process. The remainder of this Tax Topic will consider planning opportunities with life insurance.

As noted earlier, in order to retain the benefit of the small business deduction, it is common practice to retain corporate income up to the small business limit inside the corporation. This income gives rise to several planning options using life insurance that can be considered.

a) Personal and corporate insurance planning

Salary or a bonus paid to a shareholder/employee can be used for personal financial planning including the purchase of personal life insurance. Exempt insurance allows for a significant amount of tax-sheltered savings. (For a discussion of opportunities relating to the use of exempt insurance see the Tax Topics entitled "The Exempt Test" and "Personal Insurance Needs").

One of the options available with the funds retained in the corporation may be to invest it in taxable investments. However, this will cause further funds to be retained in the corporation; this excess amount will be taxed at a higher rate. An alternative to investing in taxable investments would be to put the excess profits into an exempt life insurance policy. When the

professional shareholder dies, a dividend may be paid out to the deceased shareholder's estate or holding company tax-free by way of the corporation's capital dividend account. This would allow the shares to be redeemed by the professional operating company or alternatively to provide dividends up to a holding company to redeem the shares.

A Split Dollar arrangement may also be considered in the professional corporation context. A split dollar arrangement recognizes that separate interests can be identified within a single life insurance policy. The particular interests in the policy can be matched to the parties that most require the benefits provided by the interest.

A Split Dollar arrangement can be used as a cost-effective means to provide buy-sell or key person funding while also providing a tax-deferred investment vehicle. The corporation and the professional shareholder, with the shareholder as the life insured, jointly purchase a life insurance policy. The corporation pays for and owns a level death benefit sufficient to fund the corporate insurance need. The shareholder pays for and owns the remaining interest in the policy (generally the cash surrender value).

It is important that the portion of the premium paid by the shareholder is a reasonable amount for the benefit received. If a reasonable amount is not paid Canada Revenue Agency (CRA) could assess a shareholder benefit under subsection 15(1) of the Act. (See the Tax Topic entitled "Split Dollar Life Insurance - Applications" for a further discussion of split dollar).

By using the Split Dollar arrangement, the professional corporation is provided with the insurance funding that it needs and the shareholder is provided with access to a tax-deferred investment vehicle that can ultimately be received tax-free if held until death.

b) Retirement and pension planning

Traditionally, professionals have been confined to pension planning utilizing RRSPs. As a result, professionals have only been able to contribute to their own pension planning by making contributions up to the maximum contributions permissible for RRSPs. This very much limits sources of income for professional at retirement time. The ability to incorporate now provides other options to better plan for their retirement.

Professional corporations may now consider purchasing an exempt life insurance policy with the intent of accessing the policy's cash value by collaterally assigning the policy to a bank at a later date. Accessing the cash value allows for a number of options, including using the funds to make bonus payments, to do a redemption of shares thereby providing funds at retirement to the shareholder, personal borrowing for the shareholder or providing for a living buyout using personal borrowing. See the Tax Topic entitled "Leverage Life Insurance – Corporate Ownership" for a further discussion of these options.

As discussed above, a split dollar arrangement may be used to enable the corporation to cover buy-sell funding needs and the shareholder to invest in the policy's cash value for this type of planning. Where the shareholder owns the cash value and wishes to use it to secure the loan the proceeds from the loan can then be used to provide additional cash flow in retirement.

A professional corporation may make tax-deductible contribution to an individual pension plan (IPP) or it may set up a retirement compensation arrangement (RCA) to increase a professional's retirement savings. Contributions to an RCA are subject to a 50% tax, which is refundable to the RCA when it distributes funds to the beneficiary. Note should be taken of technical interpretation (#2005-011993 dated April 25, 2005) regarding whether it would be acceptable to include the period of time during which an individual operated his or her practice as a sole proprietor before incorporation, when determining the amount of benefits which could be provided to the individual from a RCA to be funded by the corporation. CRA's response indicated that a partner or sole proprietor does not provide employment services to

the partnership or sole proprietorship and therefore such periods would not be employment services for the purpose of determining the benefits that may be provided to the individual from an RCA.

When an RCA is funded with a life insurance policy, the policy is subject to the same taxation rules as if the policy was outside of an RCA. The funds accumulating in an exempt life insurance policy are not subject to the refundable tax. Therefore, the funds are allowed to grow tax-sheltered. Any policy gains on a full or partial disposition of the life insurance policy will be subject to the 50% refundable tax. Death benefits are received tax-free by the RCA trust, but subsequent distributions to either the employer or the beneficiary would be taxable in their hands. The employer corporation, if a residual beneficiary under the trust, would not be entitled to an increase in its capital dividend account (CDA) on distribution of the death benefit from the RCA trust to the corporation.

In order to pay the retirement benefits, the trustee of the RCA trust can use policy withdrawals or use the policy as collateral for a bank loan. As noted above, policy withdrawals may cause a tax liability for the trust, but a subsequent distribution out of the RCA trust will generate a refund of the tax. In some cases, it may be more cost effective for the trust to leverage the insurance policy.

Conclusion

Because of the many options available, professionals will increasingly consider incorporating. This will provide new planning opportunities. These new planning strategies often use life insurance and as a result there are many more life insurance opportunities that may arise with the advent of more professionals incorporating.

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Appendix "A" – Who and Where Can Professionals Incorporate

Province	Professionals that can Incorporate
Alberta	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical Professionals ◇ Accountants ◇ Engineers ◇ Architects ◇ Chiropractors ◇ Dentists ◇ Physical therapists ◇ Optometrists ◇ Veterinarians
British Columbia	<ul style="list-style-type: none"> ◇ Lawyers ◇ Engineers ◇ Architects ◇ Chiropractors ◇ Optometrists ◇ Pharmacists ◇ Veterinarians <p data-bbox="609 989 1490 1073">Note: The Health Care Professions Act permits professional corporations for the professions where regulations have been established – none exist</p>
Manitoba	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical professionals ◇ Accountants ◇ Engineers ◇ Architects ◇ Dentists ◇ Pharmacists
New Brunswick	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical professionals ◇ Accountants ◇ Engineers ◇ Architects
Newfoundland	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical professionals ◇ Engineers ◇ Dentists
Northwest Territories	<ul style="list-style-type: none"> ◇ Engineers ◇ Dentists

Nova Scotia	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical Professionals ◇ Accountants ◇ Chiropractors ◇ Dentists ◇ Veterinarians
Nunavut	<ul style="list-style-type: none"> ◇ Engineering ◇ Dentists
Ontario	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical professionals ◇ Accountants ◇ Engineers ◇ Architects ◇ Social workers ◇ Veterinarians ◇ Regulated Health Professionals (audiologists, dentists, chiropractors, massage therapists, midwives, nurses, pharmacist, physiotherapist, psychologists etc.)
Prince Edward Island	<ul style="list-style-type: none"> ◇ Lawyers ◇ Medical professionals ◇ Engineers ◇ Architects ◇ Physiotherapists ◇ Psychologists ◇ Veterinarians
Quebec	<ul style="list-style-type: none"> ◇ Lawyers ◇ Notaries ◇ Engineers ◇ Accountants ◇ Doctors ◇ Land surveyors
Saskatchewan	<ul style="list-style-type: none"> ◇ Medical Professionals ◇ Engineers ◇ Dental Technicians ◇ Pharmacists
Yukon	<ul style="list-style-type: none"> ◇ Medical professionals ◇ Engineers ◇ Dentists