WOOD GUNDY

ADVANTAGES OF INCORPORATING YOUR SMALL BUSINESS

Since a large portion of our economy is fueled by Canadian business, the government encourages the incorporation of small businesses by offering special incentives. The benefits, including limited liability, the opportunity to defer taxes, and the relative ease of raising capital, can make incorporation an attractive option. The decision to incorporate a small business, however, depends upon a number of factors which vary from business to business. The following information may provide you with some insight as to whether incorporation is advantageous to your business.

Tax benefits for Canadian corporations

- Corporate tax rates are generally lower than the top personal marginal income tax rate. Incorporating may allow for significant tax deferral if a business owner is in the top marginal tax bracket, and does not require immediate access to corporate earnings.
- If a business is incorporated in Canada and controlled by individuals and/or corporations who are Canadian residents, the corporation may qualify as a Canadian Controlled Private Corporation (CCPC). CCPCs are generally subject to tax rates of about 18 percent (depending on the province) on active business income up to the "small business limit". Shareholders of CCPCs may also be eligible for a capital gains exemption on the sale of shares of a small business corporation.
- Taxable income from active businesses above the small business limit is generally taxed at corporate tax rates o f about 35 percent, depending on the province. Dividends paid out of income that has been subject to these general corporate tax rates are grossed-up by 45 percent in the hands of shareholders, who are then entitled to an enhanced dividend tax credit, reducing the impact of taxation at both the corporate and shareholder level.
- Business owners may be able to take advantage of income splitting with a spouse and adult children by employing them in the business and/or paying them dividends out of the earnings of the corporation. Care should be exercised to ensure that salaries paid are reasonable with regard to the services performed.

Limited liability

Limited liability of a corporation protects an owner's personal assets from being liquidated should the company become insolvent. Some creditors, however, may require the personal guarantee of the principals of small corporations prior to extending credit.

Perpetual existence

A corporation is a separate entity and therefore still exists despite changes in management, shareholders, or death of the owner. This can be important if a business owner would like the corporation to be run by future generations.

Ease of raising capital

The ability to borrow or to sell shares to raise capital may allow for more options when trying to fund an expanding business.

Retirement planning benefits

Individual Pension Plans (IPPs) are employer-sponsored "defined benefit" pension plans with typically one or two members, generally providing greater tax sheltered contribution room than RRSPs. These vehicles may only be established by incorporated businesses, and can be a worthwhile retirement savings vehicle to those who are over 40 years of age, are an employee of an incorporated business and earning approximately $145,000 or more annually in T4 income.

Retirement Compensation Agreements (RCAs) can also be used to provide supplemental pension benefits and tax-deferred retirement savings. Although contributions to the plan are 100 percent tax deductible, the RCA must pay a refundable tax of 50 percent of contributions and growth to the CRA. An RCA may help to protect retirement assets from potential creditors, and there is no impact to RRSP or IPP contribution limits for the employee. RCAs may be beneficial to incorporated professionals and owners of corporations who earn approximately $250,000 or more per year.

Considerations

Incorporation is not right for every business; the following are some further considerations:

- Losses earned in a corporation cannot be transferred to its shareholders. Therefore, some new businesses may not incorporate until they are expected to be profitable.
- Since the tax benefits of incorporation are based on the owner retaining earnings within the business, this may restrict cash flows for the individual owner.
- Passive investment income (i.e., portfolio investment income) of a CCPC is subject to a special tax, discouraging the earning of this type of income within CCPCs. Depending on the province, it may be beneficial to dividend out all passive income to shareholders each year to benefit from a tax rebate triggered by the distribution of passive income. The advice of your personal and corporate tax advisor is essential in making these decisions.

Life insurance options

If you've made the decision to incorporate, there are a number of life insurance strategies to consider:

Key Person Insurance: The death or disability of a key person could significantly impair the growth or stability of the business. To reduce the impact this could have, some businesses purchase a Key Person Insurance policy to protect against the potential loss of these individuals. If a key person dies or becomes disabled and therefore unable to work, an insurance benefit provides the business with the financial means to survive the impact and remain viable.

Buy/Sell Agreements: A Buy/Sell Agreement can protect your business from the potential damage of losing a partner. This type of agreement covers both the terms of ownership and the operation of a business, and should be a crucial element of any business plan.

Business transition planning: Business transition planning ensures the orderly transfer of business ownership, or the transition out of a business management role, that meets the financial needs of the owner, and ensures that the business will continue to operate.

Further reading

The decision to incorporate shouldn't be made in a day. To learn more about incorporation, and to find out if it is advantageous for your business, check out the information available on the Canada Revenue Agency and Industry Canada websites.

Canada Revenue Agency: cra-arc.gc.ca

Industry Canada: ic.gc.ca

For more information, speak to a CIBC Wood Gundy Investment Advisor.

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