

Professional corporation has tax advantage



**TAX
VIEWS**

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A professional corporation (PC) allows professionals—such as, doctors, dentists, lawyers, and accountants—to service clients through a corporate entity created under provincial or territorial corporate statutes. However, in addition to the income tax rules, provincial regulatory bodies typically control the structure and operation of such entities to ensure they do not violate or circumvent professional codes of conduct and practice. The latter rules vary between jurisdictions.

The PC rules are intended to level the playing field for professionals so that they can operate in the same way as other individuals. However, there is one significant difference between professionals and non-professionals: Shareholders of PCs cannot limit their liability for negligence or malpractice, and they remain jointly and severally liable for all professional liability claims against them.

This makes the choice of form of practice an important decision. Large law and accounting partnerships are usually better off practising as limited liability partnerships (LLPs) in order to limit the

personal malpractice exposure of their partners. On the other hand, sole proprietors and small partnerships of two to four partners may be better off practising as PCs for the tax advantages.

Tax deferral

For most professionals, the most compelling reason for incorporating is to benefit from the tax advantages available to corporations. The principal tax advantage from a PC is tax deferral. The difference between the tax payable by incorporated and unincorporated professional practices is significant. Individuals pay tax on their business income at progressive marginal tax rates. In 2015, the top combined federal/provincial marginal tax rate is about 49.53 per cent in Ontario (45.80 per cent in B.C.; 39 per cent in Alberta) starting at an income level of approximately \$138,586. In contrast, the federal corporate rate of tax is about 11 per cent (approximately 15 per cent combined federal and provincial rates) on the first \$500,000 of professional business income. The (approximately) 35 per cent point spread allows professionals to defer tax if they leave their income in the corporation. Since partners must share the \$500,000 limit between themselves, the full benefits of incorporation accrue only to sole practitioners and small partnerships.

In the April budget, the federal finance minister announced reductions in the small business tax rates from 11 per cent to nine per cent over a four-year period. Hence, it will become even more advantageous to defer taxes in the future. As a consequence of the

proposed reductions, the personal gross-up factor and dividend tax credit for ordinary (non-eligible) dividends will be also be adjusted. Alberta, New Brunswick, Nova Scotia, and Yukon announced changes as of May 15, but have not announced changes to their DTC rates as a result of the federal changes.

Tax deferral is a real and substantial tax saving, which can accumulate into very significant amounts in the end. The magnitude of any deferral depends upon the reinvestment rate and the length of time that the entity accumulates its income. Thus, professionals can use tax deferral as a surrogate pension plan.

For example, assume that Nancy, age 35, manages to save \$1,000 annually for 30 years in her PC, which, after tax, the corporation invests in securities that generate 10 per cent per year. After 30 years, Nancy extracts all of the corporation's accumulated investment profits and pays personal tax on the dividends at her top marginal rate at that time. If her net rate of tax after the dividend tax credit is 30 per cent, she will earn \$4,026 more through her corporation than she would have earned personally without her PC. The more she saves, the greater the tax deferral advantage. If she can save \$50,000 each year in the PC, the comparative advantage of incorporation grows to \$201,000.

Since tax deferral is the key to planning with a PC, one should clearly understand the mathematics of the time value of money and discount rates in advising clients on corporate structures. Without tax deferral, there is no advantage to a PC. Indeed, there

are distinct disadvantages in the form of higher costs in maintaining and operating a corporation.

Remuneration

Incorporation also enhances remuneration flexibility, and allows a choice between receiving compensation as salary or dividends. For example, professionals may wish to receive sufficient salary income to allow them to contribute to a Registered Retirement Savings Plan and Canada Pension Plan. In other circumstances, an individual may prefer dividends if he has a cumulative net investment loss (CNIL) and wishes to claim the capital gains exemption. The costs of administration may, however, outweigh the tax advantages if the professional needs to extract all of the PC's business income in each year.

Holding companies

Depending upon the applicable provincial legislation, professionals may be able to use a holding company (Holdco) to own the shares of a PC, and siphon off professional earnings to the holding company through tax-free dividends. This will reduce shareholder risk in the PC, and allow the saved cash to accumulate in Holdco. To be sure, there is no real risk in leaving surplus funds to be reinvested in the PC itself if the professional shareholder is fully and adequately insured against negligence. A Holdco, however, adds greater certainty to the structure.

There are opportunities in some provinces to split income between family members, but they should be structured only after careful

consideration of the attribution rules, and the special tax (the "kiddie tax") on certain income that minors can earn from such structures.

The kiddie tax can neutralize the benefits of income splitting business income in corporations in which the parents are active.

Professional regulators sometimes restrict the use of holding companies. For example, the Law Society of Upper Canada states: "The ownership of shares in a holding company must be restricted to licensee(s). Shares in a holding company may not be owned by family members or non-licensees. In addition, the business of a holding company must be restricted to holding the shares of the professional corporation. Applicants who intend to use a holding company must submit the Articles of Incorporation for the holding company along with their Application for a Certificate of Authorization."

PCs allow professional flexibility in arranging their business affairs for maximum after-tax retention of earnings. However, although they level the playing field of corporate taxation, PCs are subject to stringent professional regulatory rules, which require close attention as they can vary between provinces and territories, and the tax rules on income splitting.

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