Professional Corporations – What's in it for you?

Introduction

One of the decisions that you have to make as a practicing professional is the business form that you will use in carrying on your professional activities - be it a sole proprietorship, partnership, or where permitted under your governing body's rules, a professional corporation (PC). The choice of which business form is most suitable for you should be made in consultation with your professional tax advisor(s). The purpose of this article is to look at the advantages and disadvantages associated with carrying on your professional activities as a PC.

What is a professional corporation?

A PC is a corporation generally owned and operated by one or more members of the same profession (e.g. physicians, lawyers, accountants, dentists, veterinarians, etc.).

All provinces and territories allow certain professionals to incorporate. It is up to the profession's provincial/territorial regulatory body to decide whether its members may incorporate in that province or territory.

A PC differs from that of a general business corporation in that the permitted business activity of a PC is generally restricted to the practice of the profession itself, and on activities related to or ancillary to the practice of the profession, including the investment of surplus funds earned by the corporation. Other differences may include:

1) The voting shares of a PC must be wholly or majority owned by members of the same profession;
2) The officers and directors of a PC must generally be shareholders of the corporation;
3) The PC will generally be subject to the investigative and regulatory powers of the governing body for the profession; and
4) A PC will not protect a professional against personal liability for professional negligence.

As a result of these differences, some of the benefits commonly associated with incorporation may have a more limited application in respect of a PC. This is described in more detail below.

Advantages of using a Professional Corporation

1. Tax deferral

One of the most significant advantages of using a PC is the ability to defer taxes. Professional income earned through a corporation is taxed at two levels – once at the corporate level and then again at the shareholder level when the profits are distributed to the shareholder(s) as dividend income. If you do not need all the income from your practice, you can consider leaving the surplus income in your PC and defer paying tax at the shareholder level. This way you have more money to invest by keeping it inside your PC than if you paid yourself dividends and invested your after-tax money personally. Of course, once salaries or dividends are paid out to the professional, he or she has to pay personal tax on the income withdrawn, and the tax deferral comes to an end.

For example, the 2011 combined federal/provincial corporate tax rate on the first $500,000 of active business income in Ontario is 15.5% whereas the top combined federal/provincial personal marginal tax rate is 46.41%. For each $100 of active business income earned through a PC, approximately $84.50 can be left in the corporation for investment whereas if the business income was earned personally as a sole proprietor, only about $54 is left for personal investment. The difference in the amount that can be used to earn additional income (e.g., $84.50 reinvested inside the corporation vs. $56 personally) represents the potential tax deferral benefits (e.g., approximately 30.91%) of earning income through a corporation.

The greater the shareholder's personal marginal tax rate, the greater the potential tax deferral benefit since more taxes can be deferred by retaining and investing the after-tax corporate income inside the PC. Provincial or territorial regulations governing PCs should be reviewed to ensure that investment of surplus funds earned by the corporation is a permitted activity for a PC.

2. Lower overall taxes paid on the first $500,000 of income

Generally speaking, the first $500,000 of professional income earned by a PC is taxed at a lower rate. The effect of this lower tax rate means that, in most provinces and territories (e.g., limited to $400,000 of professional income in Manitoba, Nova Scotia and the Yukon) less tax will be paid overall when the first $500,000 of professional income is earned through a corporation and later distributed to the shareholders versus earning this professional income personally by individuals who are in the top marginal tax bracket.

For example, let's assume a professional or his/her PC carried on the practice in Ontario. After July 1, 2010 the combined rate of tax paid by the PC (on its income) and the shareholder (on non-eligible dividends from the corporation) is approximately 43.02%, whereas the top personal marginal tax rate on income over $127,022 is 46.41%. Accordingly, earning professional income through a corporation and later distributing this income as dividends to the shareholder provides a real tax savings of 3.39%.

3. Income Splitting

Traditional income splitting strategies such as hiring family members to work in the business and paying them a reasonable wage for services rendered can also be accomplished through a PC. Another alternative where a spouse and/or adult children are concerned, is for them to set up a management company to provide services to the PC. If this is the case, care should be exercised to make sure that the management company and the PC are not associated for income tax purposes; otherwise the lower tax rate that applies to the first $500,000 of active business income may have to be shared between the two companies. In addition, the management services charged to the PC may be subject to the harmonized sales tax (HST) in certain harmonized provinces/territories (or GST in non-harmonized provinces/territories), and since the HST may not be eligible for an Input Tax Credit (ITC) by certain PCs (e.g., those providing exempt services – physicians and dentists), the HST represents an additional and non-recoverable cost to the PC.

Where family members are permitted to own shares of the PC, an additional income splitting opportunity may be available by paying dividends to a spouse and/or adult children (but not minor children). If your spouse and/or adult children have no other income, they may be able to receive as much as $65,000 in eligible dividends (e.g., after such eligible dividends are first received by the PC from investing its after-tax earnings in public corporations) from the PC without attracting federal tax (provincial tax may payable at a lower threshold of dividend income). On the other hand, a lesser amount of non-eligible dividends (e.g., those paid by the PC itself from its lower taxed active business income) may be paid to your spouse and/or adult children.

4. Remuneration Flexibility

If your practice is incorporated, you can choose the mix of salary/bonus vs. dividends you would like to receive. As noted previously, you generally pay less tax on the first $500,000 of income earned through the PC than if you were to earn it directly. Therefore a common practice has been to receive sufficient salary and bonus income so that the taxable corporate income is reduced to $500,000. Where the amount of corporate income is less than $500,000, dividends may be preferred.

Several other factors may have an impact on the salary/bonus and dividend mix you receive from your PC. First, you may wish to receive sufficient salary and bonus to maximize contributions to your Registered Retirement Saving Plan (RRSP) and Canada/Quebec Pension Plan (CPP/QPP). On the other hand, you may prefer to receive dividend income where you have a cumulative net investment loss (CNIL) balance and you are looking to sell the shares of your PC and wish to maximize claiming your available capital gains exemption.

Lastly, as a result of the recent changes to the dividend tax rates both federally and in some provinces, dividend income may still be preferred even where the corporate taxable income exceeds $500,000 since the tax deferral benefits may outweigh the extra taxes paid (once future dividends are paid to the shareholders).

5. Accruals

A corporation can have a non-calendar year-end. By choosing a year-end carefully, several planning opportunities are available for a PC to deduct an amount

in one year, and have an employee be taxed on that amount in a subsequent (calendar) year.

One example is payment of a bonus to an employee. A corporation can deduct a bonus amount in computing its corporate income provided it is paid within 180 days after the corporation's year-end. If a corporation has a year-end of July 6th or later, the corporation is able to declare and deduct a bonus payment in that year, but does not need to pay that bonus amount to the employee until January 2 of the following calendar year. In this case, the employee who receives this amount on January 2 will be taxable on the bonus in that calendar year.

Another example is the use of an employee profit sharing plan (EPSP). In this case, an EPSP trust is created for the benefit of employees. A corporation is able to deduct its contributions to an EPSP provided it is paid within 120 days of the corporation's year-end. Provided the corporation's year-end is September 4th or later, the corporation may be able to declare and deduct the EPSP contributions in one fiscal year, but the employee is not taxed on the allocation to him/her of an amount from the EPSP until the subsequent calendar year.

6. Flexible Employee Benefits

As an employee of a PC, a professional can access certain types of employee benefits that would otherwise not be available if the professional was to carry on business as a sole proprietor or as a partner in a partnership.

For example, the professional can have the PC create an individual pension plan (IPP) and/or retirement compensation arrangement (RCA) for him/herself. These retirement savings vehicles may also provide the professional with possible creditor-protection benefits (e.g., pension benefits are protected under provincial/territorial and/or federal pension laws, and since contributions to an RCA belong to the RCA and not the employer, the money in the RCA is not exposed to the employer's creditors).

A private health services plan (PHSP) can also be established by a PC for its employees, and be used to provide health benefits for the professional and his or her family members who reside with him/her. Other advantages from using a PHSP are that contributions are tax deductible to the employer (e.g., the PC) and benefits from the PHSP are non-taxable to the employee.

7. Gains Arising From the Sale of a PC may be Tax-Free

The Canadian tax rules provide that up to $750,000 in capital gains arising from an individual's sale of the shares of a qualified small business corporation (QSBC) may be exempt from tax. This $750,000 capital gains exemption may also be available on an individual's sale of shares of a PC provided certain conditions are complied with. However, the ownership of a PC may not be easily transferred since as described above, shares in most PCs may only be owned by a member of the same profession.

8. Limited Commercial Liability

A PC does not generally protect a professional from personal liability for professional negligence. However shareholders of a PC will have the same protection as other corporate shareholders when it comes to other (e.g., trade) creditors of the PC.

Disadvantages of using a Professional Corporation

1. Costs and Complexity

The costs associated with establishing and maintaining a PC will usually be higher than that of a sole proprietorship. Additional costs will also be incurred to prepare annual financial statements, file a corporate tax return, prepare T4 slips for salaries and T5 slips for dividends. A corporation is also subject to greater regulation and compliance than a sole proprietorship or partnership.

2. Employer Health Tax and EI Premiums

Several provinces impose a provincial health tax levy once the corporate payroll has exceeded a certain threshold. Fortunately these thresholds are fairly high (e.g., in Ontario the exempt remuneration threshold is $400,000 and for payroll in excess of this amount the Employer Health Tax rate is 1.95%) so the impact of this tax on PCs may not be that significant.

Other payroll costs include the employer (PC) share of employment insurance and Canada Pension Plan contributions. In 2012, the maximum employer contribution to CPP is $2,295 for each employee (reached on pensionable earnings of $50,100) and the maximum employment insurance premium is $839.97 for each employee (reached on insurable earnings of $45,900).

3. Small Business Deduction Limit

The preferential tax rate that is available to the first $500,000 of a corporation's active business income, also known as the "Small Business Deduction" (SBD) limit, must be shared among all associated corporations. This could affect, for example, two PCs that carry on business together as a partnership and are equal partners. Each corporate partner in this case may not be entitled to the preferential tax rate on the first $300,000 of its share of the partnership income (e.g., assuming partnership income of $600,000). Rather the SBD limit must be shared between the two corporate partners (e.g., $250,000 each).

4. Business Losses

Business losses incurred by a PC cannot be flowed through to its shareholders whereas business losses incurred by a professional operating as a sole proprietorship may be used by that professional to offset his/her income from other sources.

Who Should Use a Professional Corporation?

Based on the above discussion, a PC can provide potential tax savings and tax deferral benefits. This may appeal to those professionals who do not require all their income to live on. PCs may also appeal to those professionals who wish to save for their retirement through alternative means such as a pension plan or a retirement compensation arrangement, wish to achieve income splitting with certain family members or who would like to limit their personal exposure to commercial liability.

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