Professional Corporations - Tax Planning Considerations

Wealth Management Taxation, The Bank of Nova Scotia

Several types of regulated professionals in Canada are able to carry out their business and earn income through a corporation, similar to a traditional business corporation. Generally, a professional corporation ("PC") functions like a traditional corporation with the main distinction being that a PC is governed by a regulatory professional body that restricts business activity to the shareholder's profession. Each professional governing body has its own set of rules that vary by province. This article will consider the planning opportunities applicable to corporations with a focus on those specific to a PC.

Who can incorporate?

Each province legislates which professionals may incorporate and each professional body outlines rules that a PC must adhere to. As mentioned, the permitted business activity is limited to the practice of the profession itself. In addition, several other limitations apply to PCs that do not apply to traditional corporations:

1. Voting shares of the PC must be wholly or majority owned by individuals licensed in the profession. Some jurisdictions prevent indirect ownership of any share class of PC (e.g. family members or holding companies)
2. The majority of directors must be licensed shareholders in the PC
3. A PC does not protect against personal liability for professional negligence or malpractice. However, a PC can limit the personal liability that results from financing obligations, leases and non-guaranteed bank loans
4. A PC is subject to the regulatory powers of the provincial governing body for the profession — for example, certification with the phrase 'Professional Corporation' in the legal name is required.

Benefits of incorporation

The benefits, as well as the costs, should be considered when deciding to professionally incorporate. A focus on those from a tax perspective is provided below.

Small business deduction and tax deferral

One of the primary advantages of incorporation is the ability to have income generated from business activities taxed at a low rate. Professional income earned this way (active business income) is eligible for the small business deduction on the first $500,000 annually. The tax rate applied to active business income is significantly lower than the top combined federal and provincial personal tax rates, allowing for a deferral of tax on funds retained in the corporation (see Table 1).

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	2016 Income tax rates		Deferral	
Provinces and territories	PC* %	Personal** %	%	$
British Columbia	13.00	47.70	34.70	$173,500
Alberta	13.50	48.00	34.50	$172,500
Saskatchewan	12.50	48.00	35.50	$177,500
Manitoba	10.50	50.40	39.90	$199,500
Ontario	15.00	53.53	38.53	$192,650
Quebec	18.50	53.31	34.81	$174,050
New Brunswick	14.50	53.30	38.80	$194,000
Nova Scotia	13.50	54.00	40.50	$202,500
Prince Edward Island	15.00	51.37	36.37	$181,850
Newfoundland and Labrador	13.50	48.30	34.80	$174,000
Yukon	13.50	48.00	34.50	$172,500
Northwest Territories	14.50	47.05	32.55	$162,750
Nunavut	14.50	44.50	30.00	$150,000

* On the first $500,000 of active business income
** Top bracket

When the PC distributes those funds they will be subject to personal tax. The deferral advantage is eliminated should the professional's personal needs result in all earnings each year being distributed.

Income splitting

Depending on the provincial legislation, non-professionals (i.e. spouse, children, holding companies, trusts) may be shareholders of a PC. In instances where non-professional family members are allowed to be shareholders, dividends can be paid to them as means to distribute corporate earnings within the family tax efficiently. Depending on the province of residence and assuming no other income, a certain amount of non-eligible dividends can be received effectively tax-free each year. Note that dividends paid to minor shareholders will be taxed at the top combined federal and provincial rate as the Income Tax Act's "Kiddie Tax" rules would apply.

In provinces where non-professionals are prevented from being shareholders of the PC, spouses and children can be paid reasonable salaries for services rendered to the practice. Alternatively, they could utilize a management company that receives a fee for services. Caution should be used as the management company and PC may be considered 'associated' for tax purposes resulting in a sharing of the $500,000 small business deduction limit.

Lifetime capital gains exemption

The lifetime capital gains exemptions ("LCGE") allows individuals to shelter up to $824,176 (in 2016) in capital gains from tax upon the sale or deemed disposition of a qualified small business corporation's shares up to the extent that any exemption was previously claimed. The PC must satisfy requirements on several tests with respect to the type of assets owned (primarily operating assets) by the corporation and the length of the period during which the assets were held. The accessibility to the LCGE should not be a major factor in the decision of incorporating a business, but merely another opportunity to consider. Challenges arise as purchasers generally prefer to acquire the assets of the corporation over the shares, and, salability of the shares may be diminished if it is perceived that clients will move on upon the professional's retirement.

Remuneration flexibility

A PC provides the option for professionals to pay out and receive salary or dividends. A professional may wish to collect a salary to increase the maximum amount contributable to one's Registered Retirement Savings Plan ("RRSP") and participate in the Canada Pension Plan ("CPP"). Alternatively, he or she may choose to receive dividends as there is a potential to save more in personal taxes if they are in a lower income bracket, due to the dividend tax credit.

Furthermore, a corporation can deduct a bonus from income provided it is paid within 180 days after its fiscal year-end. By choosing a year-end that is in the latter half of the calendar year, a PC may deduct a bonus payable in the current year, where the shareholder receives it and is taxed in the next calendar year.

Other planning opportunities

Probate planning

A second Will may be used to avoid probate on certain assets in some jurisdictions (e.g. Ontario). Assets, such as shares of a private corporation, which are not subject to an application for a probate grant, may be distributed this way.

Estate freeze

If the professional holds common shares in the PC, an estate freeze may be implemented. The professional may exchange his or her common shares for preferred shares that are redeemable and retractable at a fixed amount, but do not grow in value. Newly issued common shares would be allocated to family members. Note that this type of planning would be restricted in those provinces that do not allow non-professional shareholders.

Creditor protection

Creditor protection can be a significant advantage of incorporating. Generally the shareholders of a corporation are not liable for claims against the corporation. However, in the case of a PC, the professional is still personally liable for claims arising from the provision of professional services (for example, negligence claims by patients or clients). Shareholders are jointly and severally liable with a PC for professional liability, however, the professional will generally have limited liability concerning claims against the corporation by ordinary business creditors such as landlords and suppliers (subject to any personal guarantees the professional may have given).

Summary

PCs can be a great tool for reducing your family's overall tax liability.

Individuals interested in this type of planning should contact their professional advisors.