PROFESSIONAL CORPORATIONS

Presented to Professional Association of Internes and Residents of Ontario

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CHARTERED ACCOUNTANTS

INCORPORATION OF PROFESSIONAL PRACTICE

- Ontario legislation allowing regulated professionals to incorporate was proclaimed on November 1, 2001
- Professional governing bodies will be responsible for certification or licensing of professional corporations that fall under their jurisdiction
    - College of Physicians and Surgeons of Ontario, for the medical profession
- Relevant only to self-employed professionals

AFFECTED PROFESSIONALS

- Members of professions governed under:
    - The Chartered Accountants Act
    - The Certified General Accountants Association of Ontario Act
    - The Law Society Act,
    - The Regulated Health Professions Act
        - Dentists, Doctors, Chiropractors, etc.
    - The Social Work and Social Service Work Act
    - The Veterinarians Act
- See Appendix A for a more detailed list of professions

KEY FEATURES OF LEGISLATION

Professional Liability

- Corporation protects professional from normal commercial liability against creditors
- Professional (e.g. malpractice) liability will not be limited
- Each act of professional corporation deemed to be an act of the shareholder, employee or agent
- Professional is jointly and severally liable with professional corporation in respect of any liability which may flow from the corporation's errors and omissions
- Professional governing bodies will be able to "look through" professional corporations and hold the professional shareholders accountable for their actions

Name of Professional Corporation

- Must include the words "Professional Corporation" or "Société Professionelle"
- Cannot use a number name (e.g. 123456 Professional Corporation)

- College of Physicians and Surgeons of Ontario have the following additional requirements:
  - Name must include surname of one of more shareholders as set out in the College's register
  - Name may contain the shareholders' given name, initials or a combination of both
  - Indicate "medicine" or "médicine" as the health profession practiced by the shareholders
  - May not contain any information other than that required or permitted by the above
- Example of acceptable name: John P. Smith Medicine Professional Corporation

Ownership

- One or more members of the same profession may, directly or indirectly, be shareholders
- Family members cannot be shareholders, unless members of the same profession, until December 31, 2005
- Beginning January 1, 2006, family members will be permitted to own non-voting shares (doctors and dentists only)
  - Regulations to implement this change has not yet been released
  - Uncertain if family trusts will be permitted to own shares
  - If family trusts not permitted to own shares, only spouse and adult children would be able to become shareholders
- All officers and directors of the professional corporation are required to be shareholders of the corporation
- Cannot give non-professionals control of corporation through voting or other types of agreements

Business Activities

- Corporation may carry on different businesses, as long as these businesses are in the same profession
- Corporation may carry on activities that are related to, or ancillary to, the practice of the profession, including the temporary investment of surplus funds earned by the corporation

INCOME TAX CONSIDERATIONS

Eligible for Small Business Deduction

- Corporations pay lower tax rate on income eligible for small business deduction (see Appendix B for corporate tax rates on active business income, and Appendix C for personal tax rates)
    - Federal small business rate available on up to $300,000 of taxable income
- The small business deduction must be shared between associated corporations
- Ontario small business deduction benefit may be lost if associated corporation has taxable income due to "claw-back"
    - Claw-back applies even if associated corporation does not earn active business income (e.g. owns rental assets)

Tax Deferral vs Tax Savings

- Doctor may choose to be compensated by salaries or dividends or a combination thereof
- See Appendix D for integration analysis
- Tax deferral available if professional leaves income to be taxed in corporation at small business rates
- Tax savings available if professional leaves income eligible for federal small business deduction to be taxed in corporation, and receive after tax amount as dividends
- Tax savings disappear if higher income retained in corporation, but can still defer personal tax on dividends
- The decision as to whether higher income should be retained in the corporation will depend on the cash flow requirements of the professional.
    - The longer the professional plans to leave earnings in the corporation, the more valuable the potential deferral may be
    - Over time, the benefit of tax deferral may far exceed the ultimate tax cost

Capital Gains Exemption

- Professional can claim capital gains exemption if shares of professional corporation sold
- Surplus assets should be removed to ensure corporation qualifies as small business corporation at all times
- Ability to claim the capital gains exemption may be restricted if he/she has claimed investment expenses in excess of investment income (i.e. has a CNIL account), or has claimed certain types of losses (capital loss, allowable business investment loss) in the past
- Corporation may pay dividends to professional to neutralize CNIL account

Work In Progress

- Doctors are allowed to elect not to include any amount in respect of work in progress ("WIP") at the end of the year into income
- WIP has no cost for tax purposes
- On the transfer of assets to the professional corporation, the professional will be able to elect to transfer the WIP at its cost amount
- Professional corporation receives same tax treatment for WIP

Income Splitting

- Income-splitting with family members will be possible beginning January 1, 2006
    - Unknown whether family trust will be permitted to be shareholders
    - Family members who are shareholders may receive dividends from corporation
        - Family members who are not active in the business may receive dividends
        - Family members who are active in the business may receive a combination of salaries and dividends
    - Family members may realize capital gains on sale of shares of corporation
    - Family members may be eligible to claim capital gains exemption on capital gain realized on the sale of shares
- Corporate attribution rules may apply if practice transferred to a corporation that spouse or family trust (if permitted) is a shareholder, and corporation is not a small business corporation
    - Professional will be deemed to have received interest on value of assets transferred to corporation
    - Corporation will not be able to deduct deemed interest payment
    - Spouse/family trust also taxed on any dividends received from corporation
    - Double taxation may result
    - Corporate attribution not applicable if both spouses are active in business (i.e. transfer of assets to corporation by one spouse not done to benefit the other spouse)
- Corporate attribution rules may be avoided if corporation is a small business corporation at all times
    - Surplus assets should be removed to ensure corporation is a small business corporation at all times
    - Consistent with requirement that professional corporation can only have temporary surplus assets
- May continue to use the following income splitting techniques:
    - Reasonable salary to spouse/other family members
    - Management corporation/partnership owned by spouse
        - Separate small business deduction available to management corporation

- Use of trust with minor beneficiaries as shareholder of management corporation may cause corporations to be associated

MECHANICS OF INCORPORATION

- Professional elect to transfer practice assets (furniture, equipment, WIP, goodwill, etc.) on tax-deferred basis to corporation under subsection 85(1) of the Income Tax Act ("ITA")
- Elected amount is tax cost of assets (e.g. undepreciated capital cost for furniture and equipment)
- Elect $1 for assets with no tax cost (e.g. goodwill and WIP)
- Watch for goodwill that was "bumped" if professional elected to claim the capital gains exemption in 1994
    - Can elect at bumped value
- Can take back note from corporation, or have corporation assume practice liability, equal to elected amount
- Cannot assume liability in excess of cost of assets
- Professional cannot transfer excess liability, and may be necessary to retain such liability personally
- Must receive at least one share (any class) of professional corporation on transfer
- Election form is due on the earlier of the professional's, or the professional corporation's tax return due date.

Other Considerations

- Use section 22 election for Accounts Receivable to ensure any subsequent bad debt may be claimed as a deduction to corporation
- Consider transferring assets after practice year-end in order to claim tax depreciation ("CCA") personally for the full year
- Professional should generally not transfer personal cars into corporation due to standby charge rules

OTHER PLANNING POINTS AND CONSIDERATIONS

- Choice of non-calendar year-end and use of bonus accruals
    - Significant deferral for professionals with funds outside practice
        - Reduced instalments, once a year salary etc.
- Flexible remuneration options: by salary/dividends/bonus
- Ownership of practice building in corporation may be advisable to fund purchase with pre-tax dollars
    - Consider ownership by holding company
- Corporate owned life insurance
- Employee profit sharing plans and individual pension plans
- Payment of $10,000 tax-free death benefit to surviving spouse on death
- Cost of incorporation
- Annual cost of maintaining corporation: legal and tax filings
- Capital tax
    - Less of an issue since both Ontario and federal budgets provide for eventual elimination of capital tax
    - Ontario threshold $7.5 million
    - Federal threshold $50 million
- If professional owns less than 40% of professional corporation, his/her services may be subject to Employment Insurance
- Employer Health Tax up to 1.95% of salaries

APPENDIX A

- Chartered Accountants
- Certified General Accountants
- Lawyers
- Audiologists
- Chiropodists including podiatrists,
- Chiropractors,
- Dental hygienists,
- Dental Surgeons
- Dental Technologists,
- Denturists,
- Dieticians,
- Massage Therapists,
- Medical laboratory technologists
- Medical radiation technologists
- Midwives,
- Nurses,
- Occupational therapists,
- Opticians,
- Optometrists,
- Pharmacists,
- Physicians and surgeons,
- Physiotherapists
- Psychologists
- Speech language pathologists
- Respirator Therapists
- Social worker and social service workers
- Veterinarians

APPENDIX B

Corporate Tax Rates (Combined federal/Ontario)

Corporate active business income	**Corporate Tax rate effective January 1, 2005**	**Corporate Tax rate effective January 1, 2008**
Up to $300,000	18.62%	17.5%
$300,000 to $400,000	27.62%	26.5%
Active business income in excess of small business threshold (Ignore Ontario claw-back)	36.12%	35%

APPENDIX C

2005 and 2006 Marginal Tax Rates [1] on Investment Income

	Interest		**Dividends**		**Capital Gains**	
Tax Bracket [2]	**2005 %**	**2006 %**	**2005 %**	**2006 %**	**2005 %**	**2006 %**
0 – 8,148	NIL	NIL	NIL	NIL	NIL	NIL
8,149 to 11,336	16	16	3.33	3.33	8	8
11,337 to 34,010	22.05	22.05	4.48	4.48	11.03	11.03
34,011 to 35,595	25.15	25.15	8.36	8.36	12.58	12.58
35,596 to 59,877	31.15	31.15	15.86	15.86	15.58	15.58
59,878 to 68,020	32.98	32.98	16.87	16.87	16.49	16.49
68,021 to 70,554	35.39	35.39	19.88	19.88	17.70	17.70
70,555 to 71,190	39.41	39.41	22.59	22.59	19.71	19.71
71,191 to 115,739	43.41	43.41	27.59	27.59	21.71	21.71
Over 115,739	46.41	46.41	31.34	31.34	23.21	23.21

[1] Combined federal and Ontario tax rates include all surtaxes, but exclude Ontario Health Premiums, which applies to taxable income over $20,000, for a maximum of- $900 in 2005.

[2] Tax brackets assume a single filer eligible for the basic personal tax credit. Tax brackets will be higher in 2006 due to indexing.

APPENDIX D

Intergration Analysis

EARNED THROUGH A CORPORATION	Taxable income *to 300k*	Taxable income *300k to 400k*	*Taxable income over 400k*
Corporate income	$1,000	$1,000	$1,000
Corporate tax	(186)	(276)	(361)
Available for distribution (A)	814	724	639
Tax payable by the individual	(255)	(227)	(200)
Net to the individual (B)	$559	$497	$439
EARNED DIRECTLY			
Net to the individual if $1,000 earned directly (C)	$536	$536	$536
SUMMARY			
Tax savings/(cost) of earning income through a corporation, (B) - (C)	$23	($39)	($97)
Tax deferral advantage, (A) - (C)	$278	$188	$103