

OWENS, WRIGHT LLP

PROFESSIONAL INCORPORATION



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Introduction

Six years ago, the Ontario government passed legislation allowing physicians and dentists to incorporate.¹ Until recently, all shares of these "physician professional corporations" could only be owned by a member of the College of Physicians and Surgeons of Ontario (the "College"). On January 1, 2006, the *Business Corporations Act* (Ontario) was amended allowing family members of physicians to own non-voting shares in physician professional corporations. This change provides physicians with advantages already enjoyed by other owner-operated corporations in Canada – the ability to engage in "income splitting." The actual benefit to physicians (and their families) will vary depending upon individual facts and circumstances. Incorporation is not ideal for all physicians. The potential tax savings must outweigh the added legal and accounting costs of incorporation. Physicians are encouraged to contact their accountant or tax advisor to determine if incorporation is ideal for their situation.

Advantages of Incorporation

There are three benefits to incorporating, each having important tax implications.

1. **Income Splitting.** For the first time, Ontario physicians have the ability to income split. On incorporation, the corporation issues preferred shares equal to the value of the medical practice transferred to it by the physician. This freezes the value of the corporation and allows "family members" to subscribe for non-voting common shares at reasonable prices. "Family member" is limited to the physician's spouse, adult child or parent. Once the share structure has been organized, dividends can be paid from corporate income that will be taxed at the small business rate to lower income family members. A physician earning a gross annual income of \$300,000 can achieve tax savings of up to approximately \$30,000 per year by income splitting.
2. **Small Business Deduction.** A physician professional corporation will be a Canadian-Controlled Private Corporation ("CCPC"), and can obtain the benefit of the small business deduction. A CCPC is entitled to both a federal small business deduction and a lower Ontario tax rate on a certain amount of active business income earned for the year (an "active business" is any business carried on by a corporation other than a specified investment or

¹ For simplicity, this memorandum will only refer to physicians, doctors, and the College of Physicians and Surgeons of Ontario; however the same rules apply to dentists and the Royal College of Dental Surgeons of Ontario.

personal services business). The small business deduction can be used on the first \$300,000 of income. This income will be taxed at 18.62%.²

- 3. Capital Gains Exemption.** Qualifying small business corporate shares are eligible for the capital gains exemption. This can be used after a physician incorporates if he or she (or a family member) disposes of shares in the professional corporation for a gain (for example, by selling his or her practice). Up to \$500,000 can be exempted per individual. It is important to note that to qualify for this exemption, at least 90% of the corporation's assets must be business assets at the time of the sale, and more than half of the corporation's assets must have been used in an active business carried on in Canada throughout the 2-year period prior to disposition.

The Procedure

If the tax savings that can be achieved are greater than the additional accounting and legal costs, physicians should consider incorporating as an option. There are two steps to incorporating a medical practice: 1) file Articles of Incorporation with the Ministry of Government Services; and 2) receive a Certificate of Authorization from the College.

There are strict rules for naming a physician professional corporation. The name of the corporation must: 1) include the surname of the physician as set out in the College register; and 2) indicate the profession to be practised by the corporation (i.e. "medicine professional corporation").

The Articles of Incorporation set out the different classes of shares for the professional corporation. Voting shares may only be issued to a member of the College. Several classes of non-voting shares are usually created allowing the corporation may pay dividends to one family member without being required to pay dividends to other family members. This may be of assistance in the case of a divorce or estrangement. By declaring dividends, the physician is able to achieve the "income split" discussed above.

Once the Articles of Incorporation are filed and the corporation is organized, an application must be submitted to the College for a Certificate of Authorization.

Limitations

It should first be noted that the advantages of income splitting cannot be achieved if the family member shareholder is already in the highest personal income tax bracket (earning in excess of \$116,000). However, the greatest shortcoming of the new legislation is that physician professional corporations are still prohibited from arranging their company shareholdings so that a discretionary trust for all family members becomes the shareholder. The legislation specifies that shares can only be: i) legally and beneficially owned by a member of the College; ii) legally and beneficially owned by a family member of a member of the College; or iii) legally owned by

² Using 2005 rates

one or more individuals, as trustees, in trust for one or more children of a member of the College. There is no provision allowing a family trust to hold shares to benefit adult family members.

Trusts can be set up as shareholders to benefit a physician's children who are under the age of 18. However, "kiddie tax" rules will apply (these rules impose a tax on minor children who receive taxable dividends from a private corporation, either directly or through a trust – this tax will be assessed at the top marginal rate, which would eliminate any advantage of splitting income with minor children).

The Canada Revenue Agency has rules in place to prevent income splitting. The so-called "corporate attribution rules" apply when a tax-payer transfers property to a spouse in exchange for fixed-value preference shares. However, these rules do not apply for CCPC's that have at least 90 per cent of their assets used for business purposes. Physician professional corporations cannot leave retained earnings in their corporation to invest as the percentage of assets used for the medical practice will fall below the 90 per cent threshold. Physicians that have previously incorporated and accumulated significant investments in their corporations will find difficulty introducing a new spouse-shareholder.

Finally, physicians should remember that professional corporations do not offer any increased liability protection. Individual physicians (incorporated or not) will still be responsible for their own actions.

Conclusion

It should be noted that many physicians currently have "management corporations" set up, which allow the income splitting advantages discussed above without the restriction on shareholdings. However, these "management corporations" can only take part in limited aspects of the business (signing leases, hiring employees, etc.).

The new legislation provides physician with additional tax advantages which were not previously available. However, the new rules have several restrictions that physicians should be aware of before deciding to incorporate.

CHECKLIST FOR INCORPORATION

Do I want to income-split with my spouse, parents or adult children?	Yes <input type="checkbox"/> No <input type="checkbox"/>
What is the potential tax savings relative to what I am paying under my existing structure?	See below
What is the cost of incorporation?	Approximately \$3,500 in accounting, legal and College fees
What is the annual cost of maintaining this corporation?	Approximately \$2,500 in accounting fees, and \$200 in legal costs

INCOME-SPLITTING SCENARIOS

1. No Corporation

Taxable income		\$300,000
Tax payable ³	(122,348)	
After-tax income		\$177,652

2. Physician Professional Corporation – Wife and Two Adult Child Shareholders

Husband owns 50% of common shares
Wife owns 16.67% of common shares
Children each own 16.67% of common shares

Taxable income		\$300,000
Taxes payable by corporation	(55,860)	
After-tax income by corporation		\$244,140
Dividend to physician shareholder		122,070
Income to wife of physician		40,690
Income to adult child 1		40,690
Income to adult child 2		40,690
Taxes payable by physician	(22,129)	
Taxes payable by wife	(2,064)	
Taxes payable by child 1	(2,064)	
Taxes payable by child 2	(2,064)	
Total after-tax income of family		\$215,819
Less annual accounting and legal fees	(2,700)	
		\$213,119
Tax savings by incorporating		<u>\$35,467</u>⁴

³ Based on 2005 marginal tax rate of 46.1% (average tax rate of 40.78%)

⁴ Assumptions: Income of \$300,000; common shareholders – spouse, two adult children who have no other income; all after-tax income is paid out by dividend to common shareholders