IS IT TIME TO INCORPORATE YOUR BUSINESS?

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Essentially any business can be operated through a corporation instead of directly by individuals. While there are a number of non-tax reasons for incorporating a business, such as for liability protection, a corporation can be a powerful tool for deferring the payment of tax and other tax planning purposes. This newsletter will focus on corporations and some of the tax planning reasons they are used.

What is a Corporation

A corporation is a legal entity that is separate from its owners. A corporation has many of the same rights and responsibilities as an individual, such as the ability to own property, borrow money, and enter into contracts. The owners of a corporation are generally referred to as shareholders.

Taxation of Corporations & Tax Deferral Opportunities

The revenues and expenses of an incorporated business are calculated in essentially the same manner as an unincorporated business, with the corporation liable to pay tax on its net income. Unlike individuals, corporations do not have marginal tax rates. For an active, privately held business, the first $500,000 of a corporation's income is taxed at a flat rate of 15% in Ontario, compared to the top individual tax rate of 53.53% - a difference of over 38%. Income in a corporation over the $500,000 threshold is taxed at a tax rate of 26.5%.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

Due to the significant differences in tax rates between a corporation and individuals, a deferral of tax may be obtained when excess income is left in the corporation rather than being drawn out by the owner. The after tax amount of excess profits left in a company may be invested in securities, with a significantly higher amount of after tax funds available to invest.

Taking Money Out of Your Corporation

As a corporation is distinct from its shareholders, in order to withdraw money from the business there must be the payment of either a salary or dividends, the distribution of after tax profits, to an individual.

By distributing salary, the professional has the option of making RRSP contributions, thereby reducing his or her personal income by a maximum of $26,230 per year. Salary is also subject to the Canada Pension Plan and withholdings and remittances would be required by the corporation. Employment Insurance ("EI") withholdings are generally not required in closely held corporations.

Remuneration could also be in the form of dividends which, while they do not create RRSP room, have fewer restrictions on their payment as discussed below. Also, the payment of dividends are not subject to CPP but do not create an entitlement to collect CPP in the future.

> *"Incorporating your business can offer significant tax benefits"*

Income Splitting

Income splitting is achieved by the payment of dividends to low income family members who own shares of the corporation. Unlike salaries, dividends can generally be paid to any shareholder regardless of their level of involvement with the business.

While the tax legislation has rules set to eliminate any tax benefit from the payment of dividends to minor children, children who are 18 years or older may

receive dividends from a corporation. This can be quite advantageous, especially if the child has no other income and attends post-secondary studies. A spouse or age of majority child with no other sources of income can receive approximately $34,000 in dividends without paying any tax. If he or she also has college or university tuition and education credits, a larger dividend amount may be received tax-free.

If you do not want to issue shares directly to your children, a family trust may be used to hold shares for the benefit of your family members. For more information on family trusts, see our September 2016 newsletter.

Lifetime Capital Gains Exemption

Selling a business by selling a company's shares (vs. the assets of the business) is another valuable tax savings opportunity available when you incorporate your business. Each Canadian resident individual is entitled to a lifetime maximum Capital Gains Exemption ("CGE") of approximately $824,000 in respect of capital gains resulting from the sale of shares of a Qualified Small Business Corporation ("QSBC"). In simplified terms, a QSBC share is the share of an active and privately held Canadian corporation. In the 24 months prior to the sale over 50% of the corporations assets must be used in an active business carried on in Canada; over 90% of assets must be used in an active business in Canada immediately before a sale.

The CGE would not be available to an individual if he or she were to sell their interest in an unincorporated business. This CGE is also available to family members who hold shares directly or who are beneficiaries of a family trust that holds corporate shares.

Note that it is often possible to transfer an unincorporated business to a corporation shortly before a sale in order to benefit from the CGE. However, it would not be possible for family members to also take advantage of the CGE in this scenario.

Disadvantages of Forming a Corporation

Although there are many advantages, there are a few disadvantages to incorporating. There are costs associated with forming and maintaining a company, including legal and other fees of incorporation, annual accounting costs and the costs of preparing annual corporate tax returns. There are also legal fees associated with maintaining corporate minute books and shareholder resolutions. Also, any losses that may be incurred by a business would remain in the corporation and can't be used to offset personal income from other sources. Therefore, in the start-up phase of a business where there are losses or income is low, incorporation may not be practical from a tax perspective where administrative costs may outweigh the tax benefits.

Transfer of Assets to a Corporation

If you choose to incorporate, any business assets would be transferred to the newly formed corporation. Such assets may include furniture, fixtures, equipment, work-in-progress and goodwill. Established businesses may have assets with accrued gains - generally the transfer of assets can be structured so that no tax is incurred on the change in ownership from personal to corporate.

Conclusion

Incorporating your business can offer significant tax benefits if you do not require all of the annual income your company brings in, or if you have family members over the age of 18 that you can income split with. If you think incorporating your business might be beneficial in your circumstances, please do not hesitate to contact out office.

HENDRY WARREN LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

Sarah Springate, CPA, CA
Senior Tax Manager

Contact Us

Give us a call for more information about this article.

Hendry Warren LLP
881 Lady Ellen Place, Suite 200
Ottawa, ON K1Z 5L3

(613) 235-2000

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www.hwllp.ca