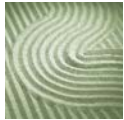
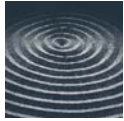


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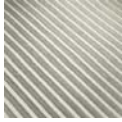
CICA National Conference on Income Taxes

Professional Corporations

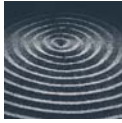
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October 14, 2010
Metro Toronto Convention Centre



Overview



1. Introduction

2. Advantages to Professional Corporations:

- a) Access to SBD
- b) Remuneration Flexibility
- c) Access to CGE
- d) Income Splitting
- e) Taxation of WIP
- f) Deferred Income Plans
- g) Miscellaneous Advantages



3. Disadvantages to Professional Corporations:

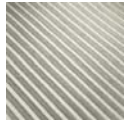
- a) Cost/Time
- b) Specified Partnership Income Rules
- c) Personal Service Business Rules
- d) Deemed Association Rules
- e) Miscellaneous Advantages

4. PC Rules across Different Provinces/Professions

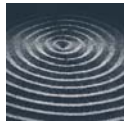
5. Professional Corporation Structures

6. Significant CRA Rulings





1. Introduction



- Professionals governed by certain professional bodies or associations are eligible to incorporate
- Option for accountants, lawyers, doctors and dentists carrying on business of professional practice
- Tax planning opportunities and structures available depend on province and profession at issue
- Must take into account the relevant provincial legislation and professional body or association
- Numerous advantages and disadvantages to consider



2. Advantages to PCs

- **Advantages to Professional Corporations:**

- a) Access to SBD
- b) Deferral of Tax
- c) Remuneration Flexibility
- d) Access to CGE
- e) Income Splitting
- f) Taxation of WIP
- g) Deferred Income Plans
- h) Miscellaneous Advantages



2a) Advantage – Access to SBD

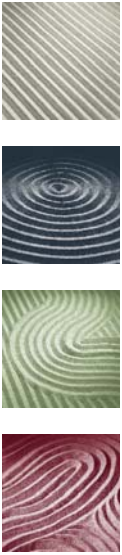
- Small Business Deduction - favourable tax rate for active business income
 - 16% tax rate in Ontario for SBD
 - Compare to 30% tax rate for regular corporate income and 46.41% tax rate for individuals
- Applies to first \$500,000 of income
 - Other than in Manitoba and Nova Scotia – first \$400,000 of income
- Tax deferral opportunities if professional retains income in PC



2b) Advantage – Remuneration Flexibility

Salary or Bonus:

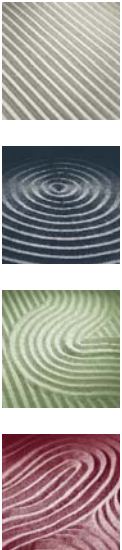
- Most basic remuneration strategy
- Payment is deductible to corporation and included in the income of the recipient
- Taxed at the recipient's marginal tax rate
- Likely subject to withholding tax at source, CPP and EI deductions
- Individual is able to maximize RRSP contribution
- Must take into account s. 18(1)(a) and s. 67 of ITA



2b) Advantage – Remuneration Flexibility (cont'd)

Salary or Bonus:

- In accordance with s. 67, salary or bonus paid must be “reasonable in the circumstances”
- Bonus/salary must be paid within 179 days of end of taxation year of corporation to be deductible
- May be reasonable if paid to spouse or children providing services to corporation, depending on circumstances

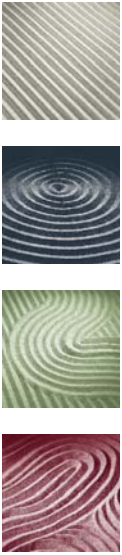


2b) Advantage – Remuneration Flexibility (cont'd)

CRA Administrative Policy:

- Long-standing CRA policy^[1] dating back to 1981 that it will not challenge the reasonableness of salaries and bonuses paid to principal shareholder-managers of a corporation where:
 1. The corporation's general practice is to distribute profits to shareholder-managers in the form of bonuses or additional salaries; or
 2. The corporation has adopted a policy of declaring bonuses to shareholders to remunerate them for profits earned by corporation attributable to know-how or entrepreneurial skills of shareholders

^[1] See “Revenue Canada Round Table” in the *Report of the Proceedings of the Thirty-Third Tax Conference* (Toronto: Canadian Tax Foundation, 1982), Q. 42

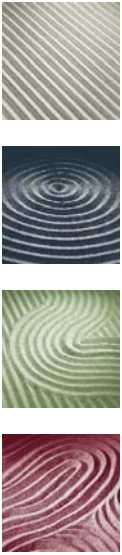


2b) Advantage – Remuneration Flexibility (cont'd)

CRA Administrative Policy cont'd:

- Policy of not questioning reasonableness does not apply to:
 - Inactive shareholders (Tech. Int. 2004-0406951I7);
 - Non-residents (e.g. Tech. Int. 2001-0092515);
 - Inter-corporate management fees (Tech. Int. 2001-0114993);
 - Income of CCPC derived from management fees or dividends that have flowed through a “complex corporate structure” (Tech. Int. 2008-0170981I7)
- According to *Income Tax Technical News No. 30*, dated May 21, 2004, CRA’s stated intent with respect to its policy is to:

“provide flexibility to a CCPC and its active shareholder/managers to take advantage of marginal tax rates by reducing the corporation’s taxable income to or below the small business deduction limit through the payment of salaries and bonuses from income that is derived from normal business operations, and to provide certainty as to the taxable status of the transactions.”



2b) Advantage – Remuneration Flexibility (cont'd)

Dividends:

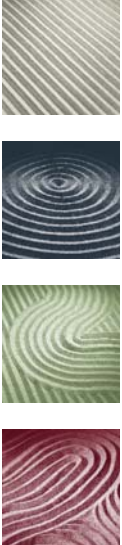
- Since introduction of eligible dividend regime, no longer an automatic decision to “bonus down” to the small business limit
- Two levels of taxation (corporate and individual)
- Eligible dividends versus Ineligible dividends
 - Business income taxed at SBD = ineligible dividend
 - In Ontario, eligible = 26.57%, ineligible = 32.57%
- Requires understanding of the concept of integration and consideration of what is most tax effective given tax rates

2b) Advantage – Remuneration

Flexibility (cont'd)

Dividends:

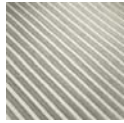
- Eligible dividends can only be paid to extent there is a positive General Rate Income Pool (GRIP) balance at the end of a taxation year
- In Ontario, rate on eligible dividends is 26.57% in 2010, 28.19% in 2011 and 29.54% after 2011 (assuming top marginal income tax rate remains 46.41%)
- Should declare eligible dividends as soon as possible as tax rates are rising even further in 2011 and 2012
- Rules for declaring an eligible dividend (i.e. dividend designation and written notice to all shareholders)



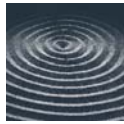
2b) Advantage – Remuneration Flexibility (cont'd)

Dividends:

- Advantages of Paying Dividends
 - RDTOH recovery
 - No source deductions for taxes, CPP, EI
 - Employer Health Tax (“EHT”) may be avoided
 - No reasonableness of remuneration test
 - Reduces cumulative net investment losses (CNILs), and increases capital gains exemption (“CGE”) claim
 - Creates safe income on hand
 - Income-splitting opportunities



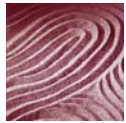
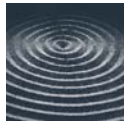
2c) Access to CGE



- Shares of PCs eligible for lifetime Capital Gains Exemption of \$750,000
- May not be useful in all professions as value in business may lie with individual goodwill rather than in PC
- Three basic tests must be met to qualify:
 - Shares must have been owned by professional or relative in last 24 months
 - During 24 months, at least 50% of FMV of all assets must have been used in active business
 - At time of sale, at least 90% of FMV of all assets must be used principally in active business



2c) Access to CGE (cont'd)

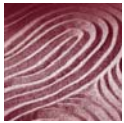
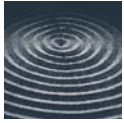


- Can incorporate immediately before sale and avoid 24 month holding rule (s. 110.6(14)(f)(ii))
- As a result of third test, passive assets cannot exceed 10% of all assets (e.g., excess cash)
 - Can “purify” corporation by moving passive assets to holding corporation (where allowed)
- May be opportunities to multiply CGE
 - Only available where non-professionals (e.g, family members) can hold shares in PC



2c) Access to CGE (cont'd)

Ability to Use Holding Corporation to "Purify"

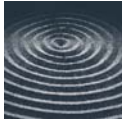


	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta				
BC				
Newfoundland				
Ontario				



2c) Access to CGE (cont'd)

Ability for Non-licensed Family Members to Own Shares in PC to Multiply CGE



	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta				
BC				
Newfoundland				
Ontario				 [Dentists only]



2d) Advantage – Income-Splitting

Salary or Bonus to Family Members:

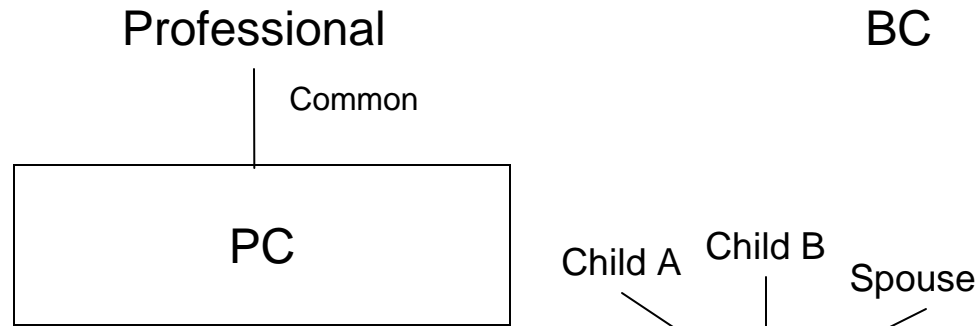
- PC cannot pay salaries or bonuses to non-active family members
 - CRA's policy that it will not challenge the reasonableness of salaries and bonuses paid to principal *active* shareholder-managers of a corporation does not apply
- PC can deduct salaries or bonuses paid to family members if the family members are active in the business
- In order to pay salaries and bonuses to active family members, the payments must be reasonable based on the work performed
- In order to be considered reasonable, the CRA must reach the conclusion that a reasonable businessman would have paid the salary/bonus at issue

2d) Advantage – Income-Splitting

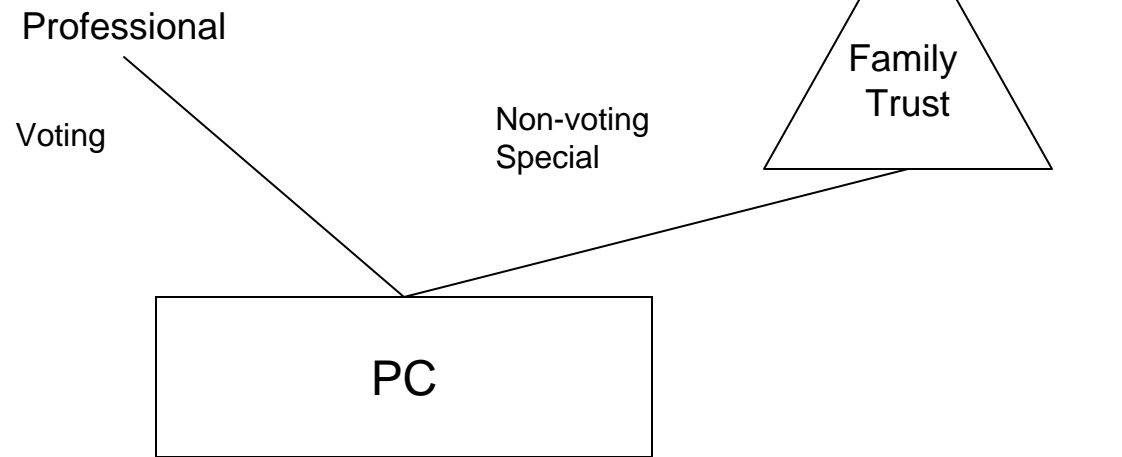
(cont'd)

Use of Trust:

Before



After



2d) Advantage – Income-Splitting

(cont'd)











Use of Trust:

- Availability depends on ability to issue shares to non-professionals
- Be aware of attribution rules such as the Kiddie Tax
- Issue of whether “dividend sprinkling shares” acceptable
 - i.e. whether separate classes of certain types of shares with same attributes on which dividends declared and paid separately acceptable
- Done in order to retain flexibility with respect to payment of dividends to different shareholders
- Potential solution to create separate classes of shares that are similar in most regards, but have nominal differences
 - e.g. alterations in voting rights
 - e.g. different rights upon liquidation

2d) Advantage – Income-Splitting

(cont'd)

Ability to Use Trust to Income Split

	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta	Where beneficiaries are Minors 	Where beneficiaries are Minors 	Where beneficiaries are Minors 	Where beneficiaries are Minors 
BC				
Newfoundland				
Ontario			Where beneficiaries are Minors 	Where beneficiaries are Minors  [Dentists only]



2d) Advantage – Income-Splitting

(cont'd)

Use of a Management Corporation:

- Shares in Management Corporation held by spouse or children
- To provide management and administration services (day-to-day operations of corporation)
 - i.e. planning, direction, control, co-ordination, systems and other functions at managerial level
- Can charge reasonable management fees in respect of services
- CRA accepts charge of a reasonable mark-up (15%)
 - Although there is case law that suggests that reasonable management fees may be more than 15% (e.g. *Bertomeu*, 2006 TCC 85)
- To be deductible, there must be a legal obligation to pay the management fees



2d) Advantage – Income-Splitting

(cont'd)

Loans to Family Members/Trusts:

- If individual lends funds to spouse, attribution rules generally apply
- Attribution does not apply if the spouse or other family member pays the annual interest by the January 30 following each year.
- Loan must be:
 - (i) governed by a written agreement
 - (ii) that stipulates repayment terms and
 - (iii) an interest rate at least equal to the CRA's then-Prescribed Interest Rate must be charged
- Family member could then re-invest loaned funds and attempt to obtain a higher return than CRA Prescribed Rate (1% in Fall 2010)
- Dividends, interest, capital gains, etc. on investments would be taxed using family member's lower marginal tax rate

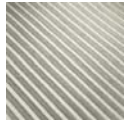


2e) Advantage – Taxation of WIP

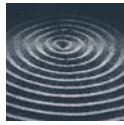
- PC required to determine income on accrual basis
- Election under s. 34 – PC can elect not to include Work In Progress in income
- Only available to dentists, accountants, lawyers, medical doctors, vets and chiropractors under s. 34
- Election made when filing tax return – no special form involved
- WIP = amount that can reasonably be expected to become receivable for that WIP after the end of the year

2f) Advantage – Deferred Income Plans

- Professional considered employee of PC – access to numerous Deferred Income Plans that can be used in combination with payment of salary/bonus and/or dividends
- Employee Profit Sharing Plan
 - Employer makes contributions to trust and allocates amount to professional – tax deductible to employer
 - Professional includes amount allocated in income
 - Tax free compounding in Plan and no subsequent tax on distribution
- Retirement Compensation Plan
 - Contributions made to a custodian and custodian holds funds in trust – tax deductible to employer, no income inclusion for employee
 - 50% refundable tax under Part XI.3
- Individual Pension Plan
 - Contribution limit based on actuarial calculations and contributions are tax deductible to employer - amounts grow tax free
- No CPP/EI withholding and allows for creditor proofing



2g) Miscellaneous Advantages



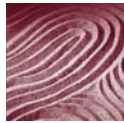
- Employee Health and Welfare Trusts



- Trade Creditor Protection

 - Protection against commercial claims

 - Distribution of assets to holding corp or family trust



- Insurance Premiums in PC

 - Corporate life insurance – deductible to corp

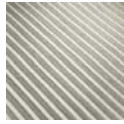
- Loss Companies

 - If individual has other corps w/ non-capital losses

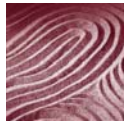
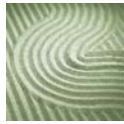
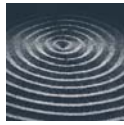
- Shareholder Loans/Housing Loans

- Non-Calendar Year Ends

 - Short-term tax deferral opportunities



3a) Disadvantage – Cost/Time



- Significant cost and time commitments may have to be made to incorporate
- Numerous costs such as legal and accounting fees for planning, filing of corporate tax returns, T4s/T5s, etc.
- PC also adds complexity to administration of professional's practice
- Requirement to maintain the corporation and require more detailed and complete records



3b) Disadvantage – Specified Partnership Income Rules

- Subsection 125(7) of the ITA - group of corporate partners must share one SBD limit
- Each corporate partner can only claim SBD equal to proportionate share of all income from partnership
- Review these Rules for any structure involving a professional corporation as a partner in a partnership
- Possible remedies include cost-sharing arrangements and creation of central PC
- Be aware of *de facto* partnership



3c) Disadvantage – Personal Service Business Rules

- Concern when exploring possibility of professional corporation or management corporation
- If PSB Rules apply, the PC will not be eligible for SBD and paragraph 18(1)(p) limits the deductions permitted
- Rules are a concern in any situation where PC bills most of his or her services to one particular corporation or partnership
- Arises in context of complex reorganizations in which partner of partnership creates a PC through which services are provided to partnership



3c) Disadvantage – Personal Service Business Rules (cont'd)

In Other Words, Where:

- an individual or a related person (called an “incorporated employee”) is a specified shareholder of Corporation A (owns more than 10% of any class of shares), and
- the incorporated employee provides services on behalf of Corporation A to Corporation B, and
- but for the existence of Corporation A, the incorporated employee could reasonably be regarded as an employee of Corporation B, then
- Corporation A will be considered to carry on a “personal services business” in a taxation year

Exceptions

- Corporation A employs more than 5 full-time employees, or
- the amount paid or payable for the services provided by Corporation A to Corporation B is received or receivable from related Corporation C



3c) Disadvantage – Personal Service Business Rules (cont'd)

- Whether found to be operating a PSB a question of fact and involves an examination of factors used to distinguish employees and independent contractors
 - i.e. tests established in *Wiebe Door Services Ltd. v. M.N.R.*, 87 D.T.C. 5025 (FCA); *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, 2001 SCC 59
- Must examine the entire relationship between the parties to determine whether employer-employee relationship existed
- Examples in context of PC - *Bruce E. Morley Law Corporation v. MNR*, (2002 DTC 1547 (TCC)) and *Criterion Capital Corp v. MNR* (2001 DTC 921) (TCC))



3c) Disadvantage – Personal Service Business Rules (cont'd)

- Even if found to be operating a PSB, no longer as costly as it once was; tax cost varies from province to province
- Weigh costs associated with paying general corporate tax rate on PSB income and paying eligible dividends, as opposed to paying salary
- Obtain deferral of income tax when leave funds in the corporation
- Significant CRA Ruling to be discussed later
 - But important to note that any restriction on competition viewed as significant factor that employee relationship exists



3d) Disadvantage – Deemed Association Rules

- If Deemed Association Rules apply, both corporations must share the SBD limit
- s. 256(2.1) – main purpose for separate corporations is to reduce income tax
 - Could argue non-tax motivation such as asset protection, estate planning or sale of business
- s. 256(1)(c) – where professional owns shares in multiple PCs (25% or more of the share of any class of other corporation)
- S. 256(5.1) – *de facto* control



3d) Miscellaneous Disadvantages

- Income Tax Withholding at Source – CPP, EI, Payroll Taxes, etc.
 - No EI if individual owns more than 40% of shares
- Specified Investment Business Rules
 - Taxed as Investment Income but dividend refund
- Restrictions on Corporate Activity
 - Holding corporation could hold investments
- Additional Registration (e.g. EHT and WCB)
- No Limited Liability against Malpractice or Negligence



4) PC Rules across Diff't Provinces and Professions

- See Schedule “A” to Paper accompanying this presentation for the Professional Corporation Summary Chart
- Chart provides a breakdown for each province for lawyers, accountants, medical doctors, dentists and optometrists
- Includes discussion on restrictions on shares and whether holding corporations are permitted, etc.
- Some of the enabling legislation is vague.

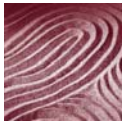
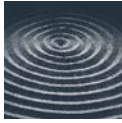
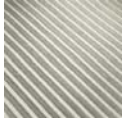


4) PC Rules across Diff't Provinces and Professions (cont'd)

- *Alberta Professional Corporations Statutes Amendment Act*

- Effective March 1, 2010
- Spouses, children and family trusts can hold non-voting shares
- Only the voting shareholder is liable personally for malpractice or negligence claims
- Holding corporations not eligible however to be shareholders
- Only family trusts with minor children as beneficiaries qualify
 - The trust shall, within 90 days from the date the child attains the age of 18 years, transfer the shares to the child

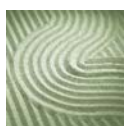
Differences Between Provinces



- Nearly all provinces allow some degree of professional incorporation; all impose shareholder restrictions
- Provinces and professions vary as to ability of trusts/holding companies to hold shares
 - Some explicitly allow both (BC, Saskatchewan)
 - Others are ambiguous and may depend on interpretation of governing body (Ontario, "directly or indirectly")
- Differences within provinces as between professions
 - Some treat all professions the same (Alberta, Saskatchewan, Manitoba [except optometrists])
 - Others place different restrictions on different professions
 - Ontario, non-voting shares held by family members of doctors and dentists only

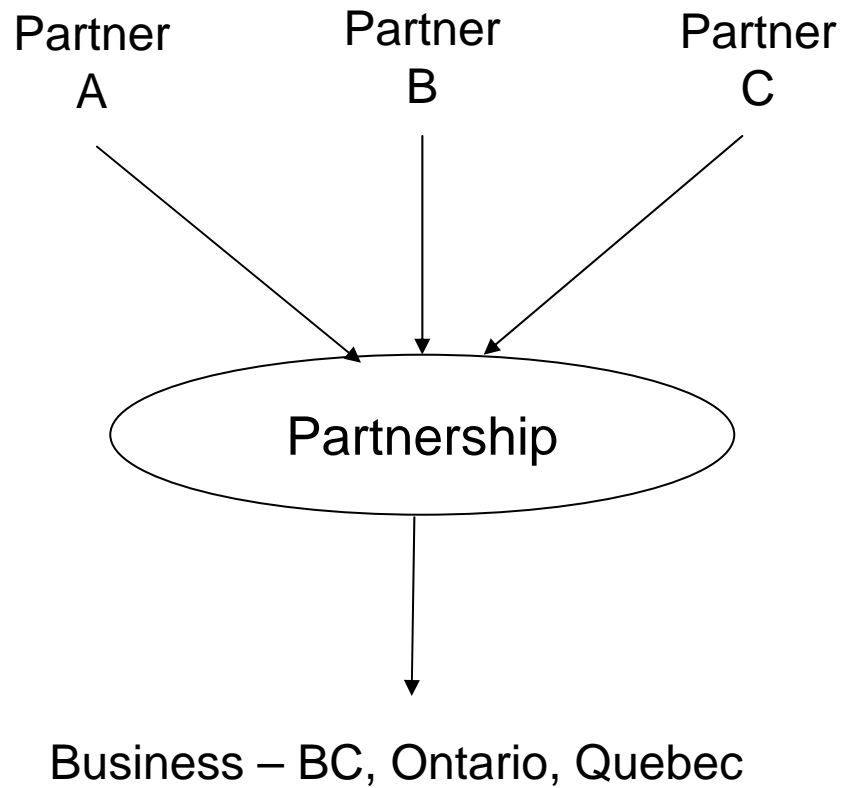
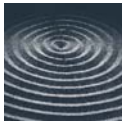
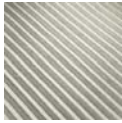
Differences Between Provinces

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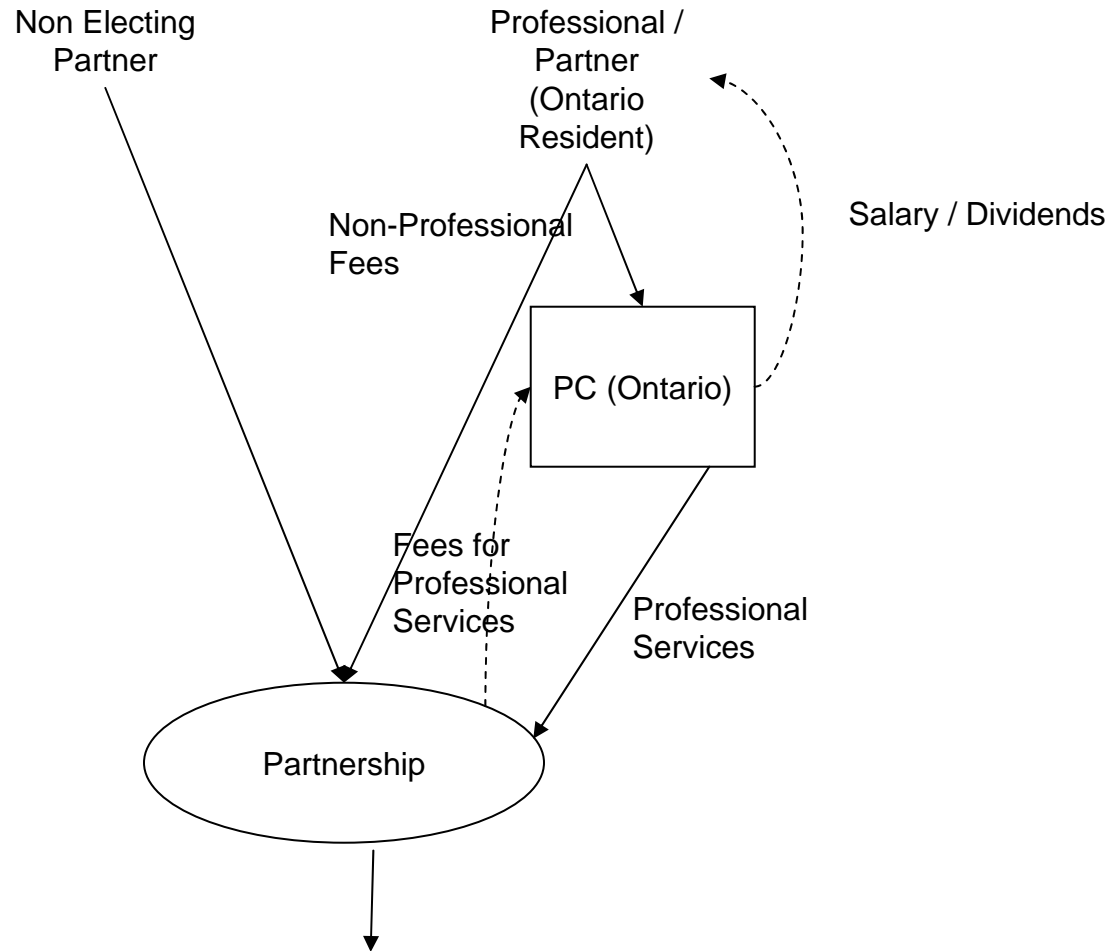


- Some provinces/professions have minimal restrictions on non-voting shares:
 - Nova Scotia lawyers: any person, corporation or trust may own non-voting
 - Newfoundland professionals (except lawyers): any natural person may own non-voting
- Legislation
 - Some provinces have blanket acts (Saskatchewan "Professional Corporations Act" for lawyers, doctors, dentists, optometrists)
 - Others are all separate Acts but use near-uniform language (Manitoba)
 - Some have no coordination between professions (Nova Scotia, PEI)

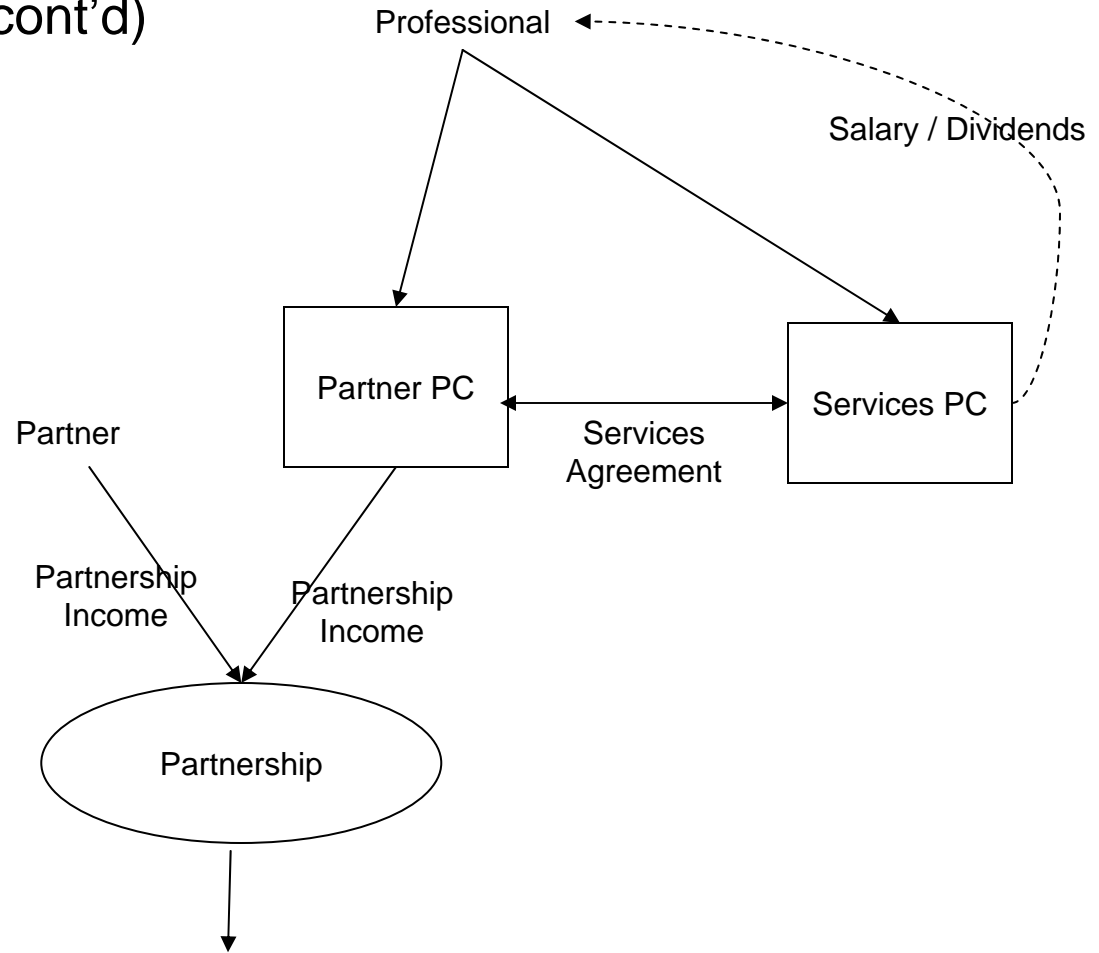
5) Professional Corporation Structures



5) Professional Corporation Structures (cont'd)

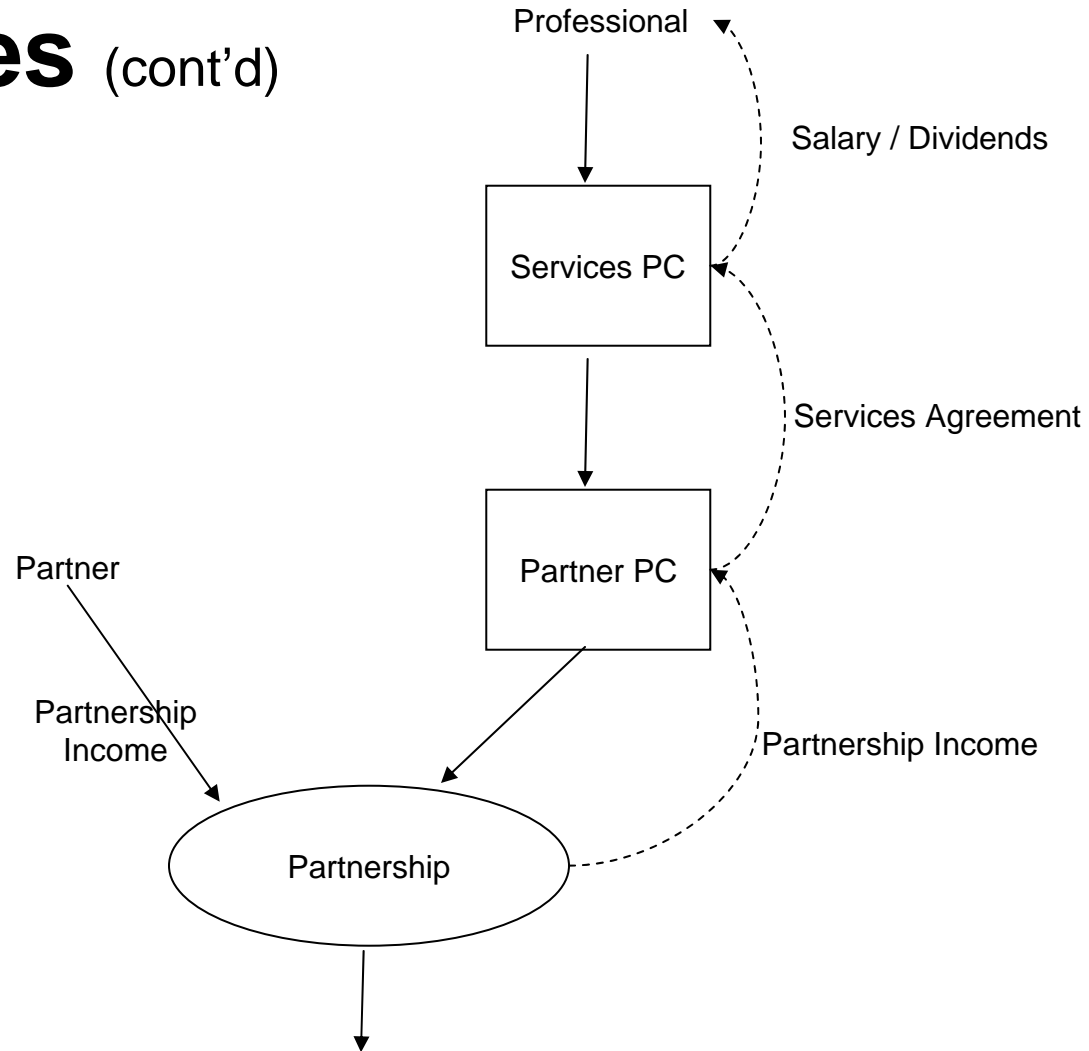
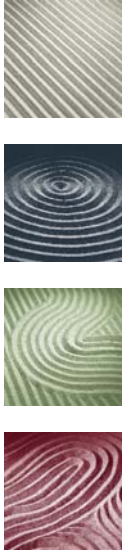


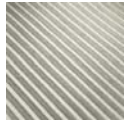
5) Professional Corporation Structures (cont'd)



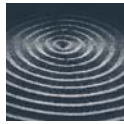
Business – BC, Ontario, Quebec

5) Professional Corporation Structures (cont'd)





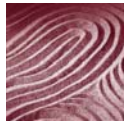
6. Significant CRA Rulings

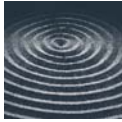
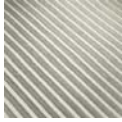


Relevant Rulings for 2009 onward are as follows:



- 2008-0279811R3; 2008-0270291R3; 2008-0292231R3;
- 2008-0300931R3; 2008-0289491R3; 2008-0290061R3;
- 2008-0282411R3; 2008-0302121R3; 2008-0290721R3;
- 2008-0280261R3; 2009-0311551R3; 2009-0318261R3;
- 2009-0338281R3; 2009-0343391R3; 2010-0357181R3.





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