
INFORMATION BULLETIN

INCORPORATION OF A PROPRIETORSHIP OR PARTNERSHIP Advantages and Disadvantages

1. Tax Rates

Corporations are presently taxed at lower rates than most individuals. The first \$300,000 per year of active income after normal expenses attracts tax at the rate of approximately 18%. Amounts over \$300,000 are subject to a rate of 45%. Note that individual tax rates vary from 0 to 49% depending on income levels.

Inactive income earned by a company, such as interest, dividends, rent or taxable capital gains is taxed at about 49%.

2. Wages and Dividends

Wages paid by a company to its employees or shareholders are deductible and reduce income subject to tax. Wages received from the company are taxable in the recipients' personal tax return in the year of receipt. Dividends paid are also taxable to the recipient, but at lower rates. However, dividends are not deductible to the company. The tax system is designed to assure that the same total amount of tax is paid by companies and shareholders no matter whether wages or dividends are taken. Because of this, there are only limited opportunities for tax reduction by channelling business income through a company.

3. Profits Left in the Company

Any profits, up to \$300,000 per year, left in the company will be taxed at the rate of 18%. If shareholders are in a higher tax bracket than this and can afford to leave profits in the company, then a real tax savings will result. Reinvested profits may be used to acquire capital assets, such as equipment, land or buildings, as a source of working capital to finance inventories or for any other purpose. If the profits are used to purchase investments, however, income from those investments will be

taxed at higher rates.

4. Income Splitting

The Income Tax Act contains numerous provisions to prevent high income earners from splitting income with low income earners in the same family. A limited company provides some methods where this may be accomplished legally. In addition, a corporation allows more flexibility in determining personal income levels. This flexibility can be used to increase RRSP contribution limits for a spousal RRSP, which is an excellent income splitting technique.

5. Capital Gains

Companies do not qualify for the enhanced capital gains tax exemption which is limited to active businesses and farms. Accordingly, if a business owns assets on which it has accrued capital gains, it may not be advantageous to transfer them to a company.

One reason for transferring a business to a company is to crystallize accrued capital gains. This is a technique whereby a proprietor or partnership sells a business to a company, reports a capital gain on the sale and claims the capital gains tax exemption to eliminate (or reduce) taxes. This is only advantageous if an election on the business assets was filed with the 1994 personal tax return claiming the now defunct normal capital gains election.

The sale of shares of a qualifying small business corporation may entitle the vendor to claim the enhanced capital gains tax exemption of \$500,000. This is clearly a very valuable tax exemption and provides strong motivation for incorporating a business.

6. Administrative Matters

The annual costs for maintaining a corporation are approximately \$700 to \$1,200 higher than for a partnership or simple personal tax returns. This is a combination of annual legal and accounting fees and is necessary to cover the costs of filing annual reports, corporate tax returns, more detailed T4 Summaries, T5 Summaries along with more complex tax planning, the preparation of directors resolutions and other matters that relate only to corporations. In addition, Workers' Compensation is no longer "optional" for shareholders; corporate tax instalments are required, and Goods and Services Tax and Provincial Sales Tax registrations are required.

7. Separate Entity

A corporation is considered to be a complete separate entity for tax purposes. This is unlike proprietorships or partnerships which are not legal entities unto themselves but rather are part of the owner's personal tax commitments. Because companies are legal entities it is extremely important for the company's assets and the owner's personal assets to be completely segregated. Profits earned by the company belong to it and cannot be taken by the shareholders, except by way of properly reported wages or dividends. This also applies to company funds held in bank accounts, cash floats and to any other assets owned by the company.

8. Limited Liability

One of the advantages of incorporation is the limited liability aspect of the company. If a business is sued, then the shareholders personal assets are not available to settle any court imposed liabilities. Liabilities incurred by the company, such as loans or mortgages are generally not the responsibility of the shareholders who cannot be held liable should the company be unable to meet its obligations. Certain important exceptions to this rule exist. For example, many creditors will not loan money to a company unless the shareholders sign personal guarantees. These negate the

limits of personal liability provided by the company. Unpaid wages, payroll deductions, corporate taxes and GST can be assessed against the directors of a company if they have not acted in good faith and made every attempt to cause the company to pay the required liabilities when due. If directors or shareholders have acted negligently in the course of providing services to the company, they can still be sued, and many professional associations require their incorporated members to retain personally full legal responsibility as a condition of incorporation.

9. Sale of a Business to a Company

Incorporating an existing operating business is deemed to be a sale of the business for tax purposes. In the absence of elections to the contrary, the sale is deemed to take place at fair market value and may of course result in personal taxes being assessed. The Income Tax Act provides a mechanism for transferring the business to a company on an essentially tax-free basis. This is referred to as a Section 85 rollover and requires various prescribed forms and elections to be filed. Despite this option, tax problems can still result from incorporation. Proprietors or partners usually have to report two fiscal periods in one year and may also have to include wages from the company in the same tax return. Additionally, if the deferral of tax is being claimed as a result of a 1995 change to a December year-end, the deferral will be cancelled on incorporation. This can result in much higher tax brackets. Also, even though capital gains tax exemptions may be claimed in the year of a rollover, costs relating to the social benefits repayment (Child Tax Benefits and Old Age Security) may be unavoidable.

The costs of incorporating the company, the tax planning and the Section 85 documents usually range from \$2,500 to \$5,000. (Sometimes higher in complex situations).

For further information, please contact your accountant at Harvey, Lister & Webb Incorporated.