5 Reasons to Incorporate Your Law Practice

By Melissa Loucks*

Lawyers often discuss the advantages of incorporating a business with clients but tend to bypass this opportunity for themselves. This article outlines five advantages of incorporating your practice.

1) Lower Taxes

Traditionally, if a lawyer incorporates he or she takes a salary. A salary means that your income is taxed at your personal tax rate. If you earn more than $130,000.00, you are in Ontario’s top personal tax rate of 46.4%.

If you incorporate your practice and pay yourself in dividends, corporate tax is paid on business income and the after tax amount is paid as a dividend. Corporations with less than $500,000.00 in business income qualify for the small business deduction and thus pay 15.5% tax. Dividends from private companies are taxed in the shareholders’ hands at a rate of 4.5%. Paying yourself through dividends can therefore result in a tax saving of 26.41%. On $200,000.00 that is a saving of $52,820.00.

Another way taxes decrease post-incorporation is through tax deferral. Tax deferral can be summarized by the adage ‘a dollar today is worth more than a dollar tomorrow’. As a result of tax savings through incorporation, surplus income not needed for living costs can remain in the company’s accounts. The surplus funds can then be withdrawn in the future or during retirement when you are less taxable. As a result, tax deferral assists with fluctuating annual income. This option is not available if you draw a salary from the company or do not incorporate your practice.

2) Decrease Payroll Taxes

Paying yourself in dividends relieves you of payroll taxes otherwise paid on a salary such as those paid through the Canada Pension Plan (“CPP”) and Employment Insurance. CPP currently pays a maximum pension of $986.67 per month. Traditionally, the ability to receive CPP payments has been regarded as an advantage of taking a salary instead of dividends. For a self-employed person, receiving CPP payments may not offer the best return on your investment. As both an employer and an employee of your firm, you are paying CPP twice. The 2012 maximum self-
employed CPP contribution is $4,613.40. Over the course of a career, maximized CPP contributions add up considerably. You may be able to invest your money more wisely elsewhere.

Also worth considering is that a capital gain in an RRSP is taxed on 100% of the gain as ordinary income. By comparison, only 50% of a capital gain is taxed if the gain occurs within a corporation.

3) Corporate Dollar Financing

Incorporating allows you to use money taxed at lower rates to pay for expenses. Most lawyers invest in business assets, (e.g., computer and office equipment, leasehold improvements, real estate). For an unincorporated lawyer, $866 in personal tax has likely been paid for every $1,000 invested in business assets. With a professional corporation, only $190 in corporate tax has been paid for every $1,000 invested in business assets. Therefore a corporation needs to earn $676 less to own $1,000 of business assets.

This strategy is particularly advantageous for buying a building or renovating a firm. A dollar earned within the corporation is taxed at 15.5% compared to a dollar taxed at a personal rate of 46.41%. Consider the example of purchasing a building where the annual loan repayment is $25,000. If the payment is made by a corporation rather than a person, there is a tax saving of $7,727.50. This is due to the 30.91% difference between the corporate tax rate and the personal rate.

4) Paying Non-Deductible Expenses

Certain expenses incurred for business purposes are not tax deductible (e.g. 50% of meals and life insurance premiums). An unincorporated professional with $10,000 in non-deductible expenses requires $18,700 in income to generate enough cash to pay for both the non-deductible expenses and the associated tax on those expenses. If a corporation incurs $10,000 of non-deductible expenses, $12,000 in income must be generated. The difference of $6,700 is equivalent to a 56% increase in pre-tax income.

5) Retirement Planning

Some professionals believe they must dissolve their corporation when they retire and will then be required to pay all of the income tax they have saved by using a corporation. This is incorrect. There is no requirement to windup your corporation. The reality is that the corporation is, in effect, a pension plan. Depending on the value of the corporation at retirement, you will be able to use the investments and investment income of the corporation in your retirement years.

With Ontario soon to be the second highest taxed province, tax smart strategies are critical. Before restructuring your practice, obtain tax advice from a chartered accountant.
Additionally, remember that unlike doctors and dentists, the Law Society prevents lawyers from income splitting, as only lawyers can be shareholders of a professional corporation.

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She also advises foreign investors, particularly from Germany, as she speaks German fluently and has worked in mergers and acquisitions in Stuttgart at an international law firm.

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