



PROS AND CONS OF PROFESSIONAL CORPORATIONS

By Chantal Desloges*



IN THE [INCOME TAX ACT](#), a professional corporation (PC) is defined to mean a corporation that carries on the professional practice of an accountant, dentist, lawyer medical doctor, veterinarian or chiropractor. By section 3.1 of the [Business Corporations Act](#), a professional corporation is defined as a corporation incorporated or continued under the [BCA](#) that holds a valid certificate of authorization or other authorizing document issued under an enactment governing a profession. Only certain vocations enjoy the privilege of being considered a “profession” for the purposes of these rules.

In Ontario, certain professionals were finally allowed to incorporate their practices around 2001. This was in response to many years of protest and complaint about unfairness directed at professionals, who were not allowed to incorporate, although other types of businesses were permitted to do so. While other small business enterprises were enjoying the benefits of lower tax rates, income splitting, choice of source of income and creditor proofing and so forth, professionals were left out.

In 2006, the [Law Society Act](#) was amended in order to allow lawyers to incorporate. Despite the fact that this amendment has been in place for a number of years now, the concept of incorporating our law practices is still a relatively new and alien concept for lawyers in Ontario. Since it is unfamiliar territory, many lawyers do not know about the plus and minus points of incorporating, and a great majority of lawyers have not taken advantage of the opportunity.

THE ADVANTAGES OF INCORPORATING

To make a long story short, a professional corporation is generally worthwhile for a lawyer when the lawyer is bringing in more money in fees than is needed for the lawyer’s living expenses throughout the year. By leaving excess funds inside the corporation rather than having to claim all of it every year on a personal income tax return, and by employing certain advanced tax strategies with the help of an accountant and financial planner, a lawyer can avoid and/or defer tax liability substantially.

(a) Lower Tax Rates and Cash basis accounting

As of 2010, incorporation allows professionals to access the small business deduction, which is a preferential tax rate on the first \$500,000 of profit for Ontario tax purposes and \$400,000 for federal tax purposes.

Simply put, in Ontario, the current combined corporate tax rate is 16.0% on income up to \$500,000 in 2011. In comparison, the highest combined marginal personal tax rate is 46.41% on income.

Therefore, if there is excess money being earned by the lawyer's practice, which the lawyer does not need for personal use during the year, it makes a lot more sense to leave that excess money inside the corporation and pay only 16% on it, compared to claiming it all on one's income tax and paying over 46% on it.

Another challenge for lawyers operating personally is that all of their business or professional income is taxed in the year it is billed, as income is calculated on an accrual rather than a cash basis of accounting. Hence, legal fees billed but not collected are taxed when billed, usually at the top rate of 46.41%, and this is regardless of the fact that collection of the payment may not take place for months. This is particularly disadvantageous at year end. If, for instance, a lawyer bills \$40,000 in the month of December, 2011, full tax is payable as part of the 2011 tax obligations, even if that money is not collected until six months later.

Use of a professional corporation alleviates much of this problem. You pay tax of only 16.0% and only on collected billings, rather than 46.41% on all billings whether actually collected or not. By using a professional corporation, the professional can pay him or herself salary or dividends at an amount just sufficient to cover required living expenses, and leave the balance of the funds in the corporation where it bears a much lower annual tax rate. The balance of funds left inside the corporation each year is called "retained earnings".

(b) Investing Retained Earnings Inside the PC

The money left inside the PC need not be left sitting in the firm's general bank account: it can be invested. For example, the corporation can purchase mutual funds, GICs and other investments in the same way that an individual person can purchase those things. This allows the money to grow inside the PC.

Although the nominal corporate tax rate on investment income (47.67%) is higher than the personal rate (46.41%), it is necessary to remember that the corporation is investing more than the individual could, because the corporation is usually paying 30.1% less tax, leaving much more to go to the investment itself. Second, a portion of the corporate tax is refundable when the corporation pays dividends to the shareholder; therefore some of the expense is recouped. Third, investment companies have certain kinds of mutual funds called "capital class" funds, which are structured in such a way that the income earned on the investments constitutes a capital gain, which attracts less tax. Overall, investing within the corporation results in substantial tax savings.

(c) Dividends vs. Salary

Even if the professional has high cash needs so that he or she cannot take advantage of tax deferral through retained earnings, there may still be tax savings by leaving income in the PC, paying corporate tax and then distributing the retained earnings to the lawyer as a dividend rather than salary. Under this scenario, the total tax on the income flowing through the PC will not exceed 42.67%. Compare this to the personal tax rate of 46.41%. Even such a small tax saving may justify incorporating the practice.

(d) Creditor Proofing

The Law Society allows the use of holding companies, and this offers some creditor-proofing and income-splitting opportunities for lawyers.

Of course, liability for professional errors flows through the professional corporation to the lawyer. The corporation does not provide protection from professional liability. For law partners, limited liability partnerships may provide more effective liability protection. However, liability for commercial contracts stops at the corporation. Therefore, for limiting financial liability on things like leases and other types of commercial contracts, use of a holding company can be very beneficial.

(e) Payment of Expenses using Corporate Dollars vs. Personal Dollars

It makes sense to have the PC pay otherwise non-deductible expenses out of its after-tax dollars, rather than the professional paying them with their after-tax dollars. For example, the lawyer can transfer ownership of life insurance policies to the corporation and then expense all life insurance premiums through the corporation. Entertainment expenses, membership fees and social sports club dues and fees could also be paid by the PC, as long as there is a reasonable probability of generating business from such activities.

THE DISADVANTAGES OF INCORPORATING

Prior to making the decision to incorporate, lawyers should consider the disadvantages, which primarily consist of extra costs and extra documentation requirements.

(a) The Expense

There are certain expenses which are associated with incorporating. First, there are the Law Society fees, which include a one-time initial fee of \$250 plus HST for the Certificate of Authorization, and an annual renewal fee of \$75 plus HST. Then there are the professional fees for the incorporation, which apply only if you hire a professional to incorporate on your behalf. Typically the average would be around \$1500 plus HST. Finally, there are extra accountant fees in the average amount of \$2000 to \$3000 extra per year for the completion of the additional paperwork and filings required for the PC, assuming that the lawyer has a regular bookkeeper (paid separately) that keeps the books up to date throughout the year.

(b) Additional Paperwork and Logistics

An unincorporated lawyer files only a personal income tax return on an annual basis. However, a PC must additionally file a corporate tax return and annual financial statements.

Once a professional corporation is established, that PC, rather than the individual practitioner, is providing professional services to the public. The individual is only entitled to practice the profession as an employee of the PC. The PC therefore must issue the lawyer a T4 slip for any salary paid out, a T5 slip for any dividend paid out, and must make ongoing source deductions for withholding tax, CPP, WSIB and so forth.

Once the practice has been transferred into the professional corporation, all signage relating to the practice should reflect operation by the PC. All business cards and letterhead should acknowledge the existence of the PC. All contacts with suppliers, whether landlords or suppliers of photocopiers or consumables, must be made in the name of the professional corporation. All revenue should be paid to the PC.

Some other things which may have to be changed:

- Leases for business premises;
- Photocopier leases;
- Telephone contracts;
- Contracts for consumables;
- Credit cards (from personal to corporate)
- Bank accounts; and
- HST number.

Notice of the creation of the corporation must be given to staff, employees and associates. New payroll deduction accounts must be established, including new employer numbers with the CRA and other government bodies. Also, Land Transfer Tax will be payable, if real estate is transferred into the PC.

CONCLUSION

Professional corporations offer substantial advantages to lawyers who choose to use this legal structure. However, there are additional expenses associated with incorporating, and some additional requirements which can be burdensome unless the advantages outweigh the time and cost. For those lawyers who generate more income than is specifically needed per year, a PC can be an extremely useful tax-avoidance and tax-deferral mechanism.

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