



Should You Incorporate? — The Tax Considerations

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When starting a new business, you face a cavalcade of tough decisions, but you're not alone. By carefully weighing all of your business and personal options, a seasoned professional can guide you in determining whether or not you should incorporate your business or simply operate as a proprietorship. Although there are added costs of incorporating your business, using a corporation will provide many tax and non-tax related benefits. The following article discusses some common tax considerations involved in the decision of whether to incorporate or not.

Anticipated Earnings

New businesses generally operate at a loss in their early years because revenues have yet to grow, efficiencies are being established, and start-up costs are present. Deducting capital cost

allowance (CCA) for tax purposes may further increase the losses. If you operate a proprietorship that has incurred a loss, you may deduct that loss from your other sources of income. Where an incorporated business incurs a loss, the loss is "stuck" inside the corporation and is not deductible against your other personal income sources. The corporation must instead deduct the loss from income that it earns in subsequent years.

Therefore, if you anticipate losses in the early years of your business and you have income from other sources, it may be beneficial to incorporate only when your business has become profitable so that you may take advantage of immediate tax savings. Once the business is profitable, incorporating may provide additional tax benefits, which are discussed below.

Tax Deferral and Savings

Canadian-controlled private corporations (CCPCs) with net assets not exceeding \$10 million enjoy a lower corporate tax rate on active business income that does not exceed \$500,000. As a result of this small business deduction, a corporation operating in Ontario will have paid a combined federal and provincial tax rate of 15% on its active business income in 2016. For example, where you are in the top bracket (a marginal tax rate of 53.53% for 2016), incorporation offers significant tax deferral since the income would be taxed at a higher rate had you been a proprietor. Note that income of a "personal service business" does not qualify

for the same preferential tax rates that active business income does. Moreover, corporations that only earn investment income and have five or less employees do not qualify for the reduced rate.

That being said, the excess cash resulting from lower taxes can be reinvested in the business itself, used to acquire passive investments (e.g., mutual funds) for the corporation, or distributed to the shareholders. The tax deferral advantage is eliminated by the dividend gross-up and tax credit mechanism when the income is subsequently distributed to the shareholders, so the main tax deferral advantage is useful when reinvesting the earnings into the corporation's business or investment portfolio. However, you may choose to time your dividend payments so that they are included in your income in taxation years that your income from other sources is lower and the dividends will be taxed in a lower bracket as a result.

If you later sell the shares of your corporation at arm's length and the corporation is considered a "qualified small business corporation", a tax deferral can be realized as permanent tax savings by utilizing the lifetime capital gains exemption. For dispositions of shares in 2016, up to \$824,176 of capital gains (that is, \$412,088 of taxable capital gains) are exempt from tax under this provision. It is crucial to consult a professional with respect to eligibility for the tax benefits discussed here as it is possible that certain corporations would not qualify. For example, if the value of the corporation's assets that are not used in its active business exceeds 10% of the fair market value of the corporation's total assets, the shares will not qualify for the exemption.

Scientific Research Incentives

If your corporation partakes in certain research and development activities, tax incentives are available that would not otherwise be available to a proprietor. For example, a CCPC may qualify for a 35% investment tax credit with respect to scientific research expenditures, but a proprietor would only be eligible for a 15% credit for the same expenditure. Further, a larger proportion of the credit may be refundable to the CCPC than what would be refundable to an individual. The term "refundable" refers to the fact that the credit will result in a cash refund to the taxpayer even if the credit exceeds taxes payable. Non-refundable credits can only reduce taxes payable as low as zero and cannot result in a further tax refund. Again, the rules surrounding the eligibility for these credits is complicated and varies by province/territory, so the guidance of a tax professional is paramount in determining whether your business activities qualify.

Provincial/Territorial Incentives

The \$500,000 active business income limit discussed in (2) above refers to federal tax rules; your province/territory may have a lower limit. All provinces and territories offer a preferential tax rate for small business corporations and may provide additional incentives to corporations. There may also be province/territory-specific tax credits which are unique to corporations.

Income Splitting and Estate Planning

A proprietor may deduct from his or her income reasonable amounts paid to his or her spouse or child for having performed employment duties. Incorporating introduces many more complex

income splitting and estate planning opportunities. When the business is in its start-up phase (presumably with a low share price), your spouse may purchase shares with his or her own money. When the business grows, and profits are plenty, the income can be split between the two of you through dividend payments. However, paying dividends to your minor children is generally discouraged as they receive unfavourable tax treatment.

That said, your children can realize the future growth in the value of the business by purchasing shares, which can split the tax burden of an eventual sale between family members and potentially multiplying the use of the lifetime capital gains exemption. If saving for your children's education is your goal, you may save a cash surplus within a holding company, and when they attain the age of 18 (and the tax treatment of dividends is no longer unfavourable), fund their education with the dividend payments. The shares in arrangements such as these are often held by trusts so that a competent decision maker can manage the property on the children's behalf.

Whether you incorporate now or later, you can split future growth in the value of the business by executing an estate freeze. This is a complex transaction that "freezes" the increased business value in your hands and transfers any subsequent increase in the value to your heirs. The general tax effect of this arrangement is the potential reduction of taxation upon your death with the continued deferral of tax accrued in your hands from the increase in the value of your business.

Conclusion

When it comes to any of the factors discussed above, it is important that a professional helps you arrange your affairs. Not only will this ensure that your business is structured to your needs, but it will also reduce the possibility of any unintended negative tax or non-tax consequences. Keep in mind that the tax factors discussed must also be balanced with many other business and personal considerations.