

INCORPORATING YOUR BUSINESS

If you are carrying on a business through a sole proprietorship or a partnership, it may at some point be appropriate to use a corporation to carry on the business. Many tax and non-tax considerations are involved in deciding whether or not to incorporate.

Not all of the issues discussed below would necessarily be relevant or decisive in any given situation. There may be unique factors in your own circumstances that could make incorporation appropriate or inappropriate. While it is not possible to describe all possible factors here, a review of some of the main advantages and disadvantages of incorporation is a good starting point.

This Reference Guide provides information in the following areas:

Advantages of Incorporation

- ❖ Limited liability and creditor protection;
- ❖ Deferring tax using the small business deduction;
- ❖ Accessing the capital gains exemption; and
- ❖ Estate planning and income splitting.

Disadvantages of Incorporation

- ❖ Legal and accounting costs;
- ❖ Trapped losses;
- ❖ Tax costs of removing assets from a corporation; and
- ❖ Double taxation at death.

ADVANTAGES OF INCORPORATION

Limited Liability and Creditor Protection

If the sole proprietor of a business is held liable in a lawsuit, his or her personal assets are at risk of being seized or encumbered by the plaintiff to pay for the

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damages. Reducing this personal exposure to liability for wrongs or debts of the business is one reason a proprietor might consider incorporating.

At law, a corporation is considered to be an entity separate and distinct from the person(s) who may be its shareholder(s) or operator(s). Generally, a shareholder may invest in the business of a corporation knowing that his or her personal risk is limited to the amount invested. If a corporation becomes involved in liability for its dealings, the shareholder's personal assets, such as his or her house and personal investments, generally cannot be resorted to by the plaintiff to enforce the debt. Similarly, if a shareholder becomes involved in liability for personal dealings, the corporation's assets are not exposed.

Once a business is incorporated, a second corporation is frequently used to provide further creditor protection to the corporation carrying on the business. A holding company ("Holdco") may be used to hold valuable assets such as land and buildings separate from the corporation that operates the business ("Opco"). Opco is usually more likely than Holdco to become involved in liability.

However, there are certain exceptions to the strict separation of the roles of corporation and shareholder. In certain circumstances an individual may be held personally liable for the actions of the corporation. For example, environmental protection laws generally provide that shareholders, directors and possibly other employees of a corporation may be held personally liable for the corporation's environmental wrongs. When legislation or the courts disregard the separation between the corporation and the individual, it is commonly referred to as "piercing the corporate veil."

Deferring Tax Using the Small Business Deduction

One significant tax advantage of incorporating a business is the ability to defer a substantial portion of the tax on the income of the business. This tax deferral is often the main reason someone first considers incorporation.

How the Deferral Works

Tax deferral is achieved by having the corporation retain some of the business income, where it is taxed at significantly lower rates than if it were earned personally.

Using a corporation to defer tax is similar to using an RRSP to defer tax. Tax on income contributed to an RRSP is deferred until funds are withdrawn. With a corporation, a portion of the tax on active business income retained in the corporation is deferred until the corporation pays out (or is deemed to pay out) the retained earnings as a dividend or the shareholder disposes of (or is deemed to dispose of) his or her shares.

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Currently, the maximum amount of tax that can be deferred each year by incorporating a business in Canada can be up to \$120,000 (this maximum will be higher or lower depending on the province in which you live). The key to the deferral strategy is the small business deduction which reduces the tax rate on the first \$400,000 of active business income retained in a Canadian controlled private corporation ("CCPC"). The tax deferred is based on the difference between the rate you are currently paying on your business income, and the rate that the corporation would pay.

For example, the highest marginal tax rate for individuals in 2008 is approximately 46%. A corporation would pay approximately 16% tax on the first \$400,000 of that income in 2008. Therefore, the maximum annual tax deferral is approximately $\$400,000 \times (46\% - 16\%) = \$120,000$.

Please note that these tax rates and the maximum deferral amount are based on an average of all provincial rates. The rates and the deferral amount that would apply to you will be higher or lower, depending on the province in which you live. Please see Appendix A of this Guide for your province's rates and maximum deferral amount.

Where retained earnings are not paid out as dividends, or where shares are not disposed of, the longest that the tax can be deferred is until the death of the shareholder of the corporation. Tax could potentially be deferred until the death of a surviving spouse who inherits the shares from the original shareholder. At death, an individual is deemed to dispose of all of his or her capital property (which would include the shares of a corporation), unless the property passes to a spouse (or a spousal trust in certain circumstances). The deemed disposition at death will trigger all capital gains accruing on the shares.

Dealing with Active Business Income Over \$400,000

Where a corporation has business income in excess of \$400,000, it is generally advisable for the corporation to pay such excess out as salaries or bonuses, which are treated as before-tax expenses of the corporation. Although a salary or bonus is taxed as regular income to the shareholder, this avoids an even higher combined rate of tax that would result if such amounts were taxed in the corporation and then paid out as taxable dividends. Salaries and bonuses must be reasonable in relation to the value of the services performed by the recipient.

Note that if a corporation's active business income is less than \$400,000 in a given year, sufficient salary should still be drawn by the shareholder to maximize RRSP contributions.

Determining Whether You will Benefit from the Deferral

Basically, from a tax perspective you should consider incorporating a business if you are currently earning income from that business that is in excess of the funds

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necessary to support your lifestyle, you are currently maximizing your personal RRSP contributions, and there is enough time after incorporation before retirement to make the deferral worthwhile. It will be necessary to estimate your annual personal lifestyle expenditures including annual RRSP contributions, estimate your annual income from your business, and determine your desired retirement date.

Incorporating your business will generally only provide a tax deferral benefit where the business generates enough income so that all of the following apply:

- ❖ The income generated by the business is more than enough to meet your after-tax lifestyle expenses (including any family expenses).

If the business generates only enough (or less than enough) income to meet your lifestyle expenses, there will be pressure to use the corporation's retained earnings. Using corporate property for personal purposes will attract tax personally, making incorporation less advantageous. Using retained earnings to acquire business assets, such as equipment or real estate used in the business, makes incorporation advantageous. A corporation will have more after-tax dollars to acquire business assets.

- ❖ The income generated by the business is also more than enough to allow you to make the maximum RRSP contributions to the shareholder's and shareholder's spouse's plan.

Generally, RRSPs provide a greater tax deferral than corporations do. RRSP contributions are fully deductible and therefore are not taxed (as opposed to merely being taxed at a lower rate as with corporations). The investment income earned inside an RRSP is not taxed until withdrawn, whereas investment income earned in a corporation is fully taxed. Therefore, using a corporation to defer tax is only advantageous if you are maximizing RRSP contributions.

- ❖ The income generated by the business is also enough to permit the corporation to retain sufficient earnings to make the costs of incorporation worthwhile.

The costs of incorporating will include initial and ongoing professional fees.

- ❖ The use of the income retained in the corporation for personal purposes can be deferred for a sufficient period of time to make incorporation worthwhile.

The shorter the time that tax is deferred or postponed, the smaller the deferral benefit will be. Therefore, if retained earnings will be distributed, or the shares of the corporation are disposed of (or deemed to be disposed of), within a relatively short period of time (less than perhaps five years),

incorporation may not be worthwhile as far as the small business deduction is concerned.

Limits on Access to the Deferral: Associated Corporations

Where two or more CCPCs are “associated” under the Income Tax Act, the ability to access the small business deduction will be affected. The associated corporations must agree to allocate the \$400,000 small business deduction limit between them. If they fail to do so, they risk losing the deduction or having the Minister of National Revenue make the allocation for them. Generally speaking, two corporations are “associated” if they are directly or indirectly controlled by the same person or related group of persons. The associated corporations rules are complex, and association may arise in several other ways. In certain circumstances there may be ways to structure the ownership of two corporations so that they are not associated.

Accessing the Capital Gains Exemption

Canadian tax legislation provides a \$750,000 capital gains exemption on the disposition of shares of a qualified small business corporation (“QSBC”). In the right circumstances this can be a great benefit of incorporation. The \$750,000 capital gains exemption for QSBC shares is available only to individuals who are resident in Canada throughout the year. It is reduced to the extent that capital gains exemptions were claimed in previous taxation years¹. The amount of the exemption that may be claimed may also be reduced by any net capital losses claimed by the individual for the year, any allowable business investment losses claimed by the individual and the individual’s cumulative net investment loss at the end of the year.

When is the Capital Gains Exemption Useful?

It should be noted that generally, the capital gains exemption only provides an advantage if the shares of the corporation are sold to an unrelated person, or at death when a deemed disposition occurs. In considering whether or not the capital gains exemption will be an advantage of incorporation, it will help to consider whether or not you will be able to sell shares, rather than assets, of your business to an unrelated person.

In some cases taxpayers consider “crystallizing” the capital gains inherent in their QSBC shares through certain reorganizations in which capital gains are triggered but sheltered from tax using the capital gains exemption. The result is shares with high adjusted cost base (ACB). Since ACB represents tax-paid value in the

¹ The enhanced capital gains exemption available upon the disposition of QSBC shares may be reduced to the extent that the individual has previously used the “general exemption” of \$100,000, which was repealed in 1994, or any capital gains exemption related to QSBC shares or certain qualified farm property.

shares, it should be possible to remove or "strip" assets such as cash from the corporation free of tax. However, where the ACB has resulted from your use, or a related person's use, of the capital gains exemption, certain "anti-stripping" rules would prevent you from stripping corporate assets in this manner. These anti-stripping rules would generally apply with the effect that amounts stripped from the corporation in this manner would be treated as taxable dividends rather than tax-free payments in respect of ACB. Therefore, as noted, the capital gains exemption generally only provides a tax advantage if you can sell your QSBC *shares* (rather than assets of your business) to an unrelated person, or at death when the deemed disposition occurs.

QSBC Share

In order to qualify for the enhanced capital gains exemption, an individual must dispose of a share of a QSBC. There are a number of stringent tests that a corporation would have to satisfy before its shares could be QSBC shares. One of the tests requires that at the determination time (i.e. the time you dispose of the shares), the shares must be shares of a "small business corporation" ("SBC"). A CCPC is an SBC where 90% of the fair market value of its assets are used in an active business carried on primarily in Canada. Another test is that for a period of 24 months before the determination time, the shares must meet a similar test, with a 50% active asset threshold applying.

Where the shares of a corporation do not qualify as QSBC shares because the corporation owns excess non-eligible assets, various strategies may permit the "purification" of a corporation by removing the non-eligible assets from the corporation.

Estate Planning and Income Splitting

Incorporating your business may help to facilitate your estate and succession planning, and may create income-splitting opportunities. Usually a business would initially be incorporated for reasons other than estate planning, such as accessing the small business deduction, or for protection of personal assets from creditors. Later, when the business is mature and has appreciated significantly in value, a corporate structure involving a "freeze" (often called an "estate freeze") is commonly considered. However, it is possible to incorporate a business initially with a freeze structure in place, if appropriate.

A freeze structure may:

- ❖ allow you to defer and minimize capital gains taxes upon a sale of your business or at death,
- ❖ assist in facilitating the succession of your business to other family members such as children, and

- ❖ allow you to split income with lower-tax-rate family members through dividend payments.

To implement a freeze of your interest in a corporation, you would exchange your shares for a new class of preference shares having a redemption value equal to the value of the exchanged shares. Your family members or a family trust would subscribe for new growth shares.

Using a Family Trust

A family trust is often used as part of a freeze. Children and other family members, including future grandchildren, are usually the beneficiaries of such a trust. Rather than issuing the new growth shares directly to the family members, the new shares are issued to the family trust. A family trust would be appropriate if you wish to maintain control over the new growth shares, and if you wish to defer the decision as to which family members will receive the shares and in what proportions.

Minimizing and Deferring Capital Gains Taxes

A freeze fixes the value of your interest in the corporation at its current value, allowing future growth in value in the corporation to accrue to your family trust (and eventually to your family members) instead. If you have accumulated enough wealth to maintain your lifestyle for the rest of your life, freezing may be desirable, as it can limit the capital gains taxes you will realize personally upon a sale of the business, or at death when a deemed sale occurs. It may be possible to defer the realization of capital gains on the new growth shares for many years after your death - until your family members later dispose of their shares.

If you are not sure whether you will require some of the future growth of the corporation to fund your lifestyle expenses, it is possible to structure the freeze so that some or all of the new growth shares can be transferred to you, in addition to or instead of the other family members. This requires careful planning to ensure that certain income "attribution rules" are not offended.

Income Splitting

To accomplish income splitting, dividends could be paid on the new shares from future earnings of the corporation. Those dividends could be received by the other family members (either as direct shareholders or indirectly through the family trust). If the family members are in lower tax brackets, this would save income tax.

Attribution Rules

Several kinds of "attribution rules" may apply to an estate freeze if it is not implemented correctly. If the attribution rules apply, income or capital gains from

the shares issued to the family trust might be attributed back to you, preventing income splitting, and possibly ruining the opportunity to minimize capital gains tax. However, these kinds of attribution rules may be avoided where the reorganization of the corporation and the family trust are implemented properly.

Another kind of attribution rule that can apply in the context of a freeze is "corporate attribution". Corporate attribution is a kind of deemed interest income that may apply to you where certain family members, such as a spouse or minor-aged relatives, are beneficiaries of your freeze. Avoiding corporate attribution will involve a careful consideration of whom to include as beneficiaries of the freeze or family trust, or drafting the family trust with special provisions that make corporate attribution inapplicable. Another way to avoid corporate attribution is to carefully maintain the corporation's status as a "small business corporation" (discussed above).

Income Splitting Tax

It is generally no longer possible to split income through dividend payments to minor children, grandchildren, nieces, or nephews through a freeze structure. The "income splitting tax" (often called the "kiddie tax") provides that dividends received by a minor child from a private corporation are taxed at the highest marginal rate, thereby eliminating the income splitting benefit. However, such income splitting becomes possible beginning in the year a child will reach age 18.

DISADVANTAGES OF INCORPORATION

Legal and Accounting Costs

The costs of incorporating and maintaining a corporation are modest in relation to the potential tax benefits. However, you will need to obtain an estimate of the initial and ongoing cost of incorporation from your legal and accounting professionals. A corporation requires more attention and entails more complexity, since personal and corporate property and expenses must be kept strictly separate. There will be legal costs for drafting and preparing minutes and resolutions, as well as accounting costs for preparation of financial statements and corporate tax returns. Unless a meaningful amount of tax is deferred or eliminated, the added expense and complexity of a corporation is not worthwhile to most individuals.

Trapped Losses

If a business is not profitable, it may accumulate losses. If the business is already incorporated, these losses may be "trapped" in the corporation. Since a corporation is a separate legal entity, the losses of a corporation are not available to the individual shareholders or to other corporations to deduct against their own income. Accessing or using corporate losses can be difficult. For example, it may be necessary to inject income into the company, find other ways of creating

income in the company, or reduce the expenses of the company by incurring the expenses personally. Other corporate loss utilization strategies may be complex, and may be subject to certain anti-avoidance rules.

Where start-up losses are expected, it may be preferable to operate the business as a proprietorship or through a partnership for a time so that losses may be accessed personally and used to offset income from other sources.

Tax Costs of Removing Assets from a Corporation

Canadian tax laws generally allow assets to be transferred to a corporation on a tax-deferred basis. However, removing assets from a corporation can result in tax to the corporation and/or the individual receiving the assets. This is a potential tax problem that is common to almost all corporations.

Consequences to the Corporation

When assets are transferred out of a corporation to an individual, the assets are normally considered to have been disposed of by the corporation for fair market value proceeds. In the case of capital property, capital gains may result in the corporation and be subject to tax. If the capital property is depreciable property, any inherent recapture in the property would be realized as taxable income of the corporation.

Therefore, in making any distribution out of a corporation, you will need to determine which corporate funds are used for that purpose. Ideally, liquid assets would be used. If it is necessary to liquidate any of the corporate assets to make the distribution, this would trigger any unrealized gains or losses in those assets. Assets can be distributed by the corporation "in kind" but this would be a disposition of the assets and thus trigger any unrealized gains.

Where a corporation has an asset the value of which is lower than its cost, the corporation might also realize a capital loss on a transfer to an individual. A capital loss may be seen as useful since the corporation may be able use it to offset taxable capital gains. However, in certain circumstances such as, for example, where the individual controls the corporation, certain "stop loss" rules may apply. These rules may result in the capital loss being "suspended". In that case, the corporation would not be able to claim the loss on its tax return until the individual has actually disposed of the asset. Certain planning may be available to avoid the application of such stop loss rules.

Consequences to the Individual

Generally any transfer of assets or value from a corporation to an individual shareholder will be treated as a dividend to the shareholder, which may be subject to tax in the shareholder's hands. (Different rules apply if the shareholder is itself a corporation.)

Opportunities to Extract Corporate Funds

Careful planning using the available tax rules can help avoid unnecessary tax costs when assets are eventually transferred out of a corporation. Such planning commonly involves concepts such as the following:

- ❖ Making use of the corporation's capital dividend account (CDA), which, when available, allows the payment of tax-free dividends to a shareholder. The CDA of a corporation is generally increased by amounts such as the tax-free portion of capital gains, and tax-exempt life insurance proceeds received by the corporation;
- ❖ Accessing any outstanding shareholder loan, which is another tax-free source of corporate funds;
- ❖ Making use of the corporation's refundable dividend tax on hand (RDTOH) account. RDTOH is created when a corporation earns income such as investment or property income (as opposed to active business income). A corporation must pay a certain amount of refundable tax to the government. Certain amounts of this tax are refunded to the corporation when it pays dividends. Where RDTOH is available, the overall tax cost of paying dividends or redeeming shares is reduced;
- ❖ Making use of the adjusted cost base (ACB) of the shares of a corporation. The ACB of shares is essentially what the shareholder paid for the shares if they were purchased from someone else. The ACB of shares can in some circumstances be increased through certain reorganizations and by the use of tax exemptions like the \$750,000 capital gains exemption. High ACB may allow funds to be extracted from a corporation on a tax-free basis. This generally requires reorganization involving the use of a new holding corporation. Certain "anti-stripping" rules, which may result in immediate unintended tax, must be carefully considered before implementing such a transaction; and
- ❖ making use of the paid-up-capital (PUC) of the shares of a corporation. PUC is essentially the amount of money a shareholder paid to subscribe for his or her shares, subject to certain adjustments. PUC may generally be paid back to the shareholder as a tax-free return of capital. Additionally, higher PUC normally results in a lower deemed taxable dividend upon the redemption of shares.

Double Taxation at Death

On the death of the shareholder of a corporation, there may be a potential double taxation problem. The value of the shares of the corporation represents the value of the underlying corporate assets. At death, the shares are generally

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deemed to have been sold for proceeds equal to this value.² If the value of the shares is greater than their cost for tax purposes, this appreciation in value will be realized and taxed as a capital gain.

A second level of tax may result when the corporation disposes of the underlying corporate assets and/or when the corporation is wound up. When the corporation disposes of its assets or winds up, it may realize capital gains to the extent that the underlying corporate assets have gains. Thus, the same value that was taxed in the hands of the shareholder at death is again taxed, this time in the hands of the corporation. This is another potential tax problem that is common to almost all corporations.

With careful tax and estate planning, the double tax problem can be mitigated or in some cases completely avoided. Such planning may be implemented during the shareholder's life, for example, when a corporation is being wound up. The executors of a deceased shareholder frequently need to implement such planning after the death of the shareholder. The planning required may be complex.

CONCLUSION

A corporation may provide significant tax benefits for you if your business generates enough income to create a significant tax deferral using the small business deduction. A corporation may also create opportunities to reduce your family's tax burden by splitting income with low-rate family members. Many other facts and circumstances, including potential costs and complexity, will need to be considered by you and your financial, tax and legal advisors to determine whether a corporation is right for you.

² If the shares are transferred at death to a spouse or a qualifying spousal trust, this deemed disposition may be deferred until the spouse disposes of the shares or dies. This discussion assumes there is no transfer to a spouse or spousal trust at death.

Appendix A
MAXIMUM DEFERRAL BY PROVINCE IN 2008

Province	Highest Rate for an Individual's Income	Rate on Active Business Income up to \$400,000	Maximum Deferral Using A Corporation
British Columbia	43.7%	15.5%	\$112,800
Alberta	39.0%	14.0%	\$100,000
Saskatchewan	44.0%	15.5%	\$114,000
Manitoba	46.4%	13.0%	\$133,600
Ontario	46.4%	16.5%	\$119,600
Quebec	48.2%	19.0%	\$116,800
New Brunswick	47.0%	16.0%	\$124,000
Nova Scotia	48.3%	16.0%	\$129,200
Prince Edward Island	47.4%	14.2%	\$132,800
Newfoundland and Labrador	45.5%	16.0%	\$118,000
Northwest Territories	43.1%	15.0%	\$112,400
Nunavut	40.5%	15.0%	\$102,000
Yukon	42.4%	15.0%	\$109,600