Tax + Estate Business Owners Kit

Part 1 Deciding on a business structure

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Business owners have unique financial, investment, tax and estate planning needs.

Because most of their time, energy and resources are spent on the business, it is easy to give planning a lower priority.

That's why working with a financial advisor will not only help you put your unique plan in place but will also result in an improved plan. The following material will help you get started in discussions with your advisor. This is Part 1 of the Tax and Estate Planning for Incorporated Business Owners series, which focuses on financial, investment, tax and estate planning strategies specific to incorporated business owners, including professionals.

Many opportunities become available through incorporating your business. For other business owners, a sole proprietorship may be the best structure. Part 1 compares the advantages and disadvantages of the various forms of business ownership, including incorporation. It also addresses the question of whether you should incorporate your business or practice – a common question for entrepreneurs who seek to maximize protection of assets and/or minimize tax on business income.

This is Part 1 of the Tax and estate planning for incorporated business owners series

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Sole proprietorship

A sole proprietorship is the simplest business structure to start and maintain. With a sole proprietorship, one individual owns the business and its assets, and is solely responsible for all debts and obligations of the business. In exchange, the business owner can make all decisions and is entitled to all profits.

As sole proprietor, you are considered self-employed and would generally perform all functions required to successfully establish the business including securing capital, establishing and operating business processes and paying all taxes (which are calculated and reported on your personal income tax return). Since a sole proprietorship is simply an extension of the business owner (and not a separate entity), business losses can be used to reduce other income on your personal tax return including investment, rental and/or other income. On the other hand, should the business not have enough income and assets to fulfill its debt obligations, creditors would normally have access to your personal assets. This is known as unlimited liability.

Unlike many corporations, sole proprietorships tend to have difficulty obtaining capital since it is not possible to issue shares in exchange for the investment. It may also be difficult to secure key employees as there are generally fewer resources and limited opportunities for career advancement. However, it is typically less costly to operate a sole proprietorship as government reporting requirements tend to be less onerous than the requirements for corporations.

Sole proprietorships are generally suggested for new businesses that do not carry the threat of personal liability and usually generate business losses that may be used to offset other personal income sources.

Advantages

- Ability to make all decisions
- Entitled to all profits
- Simple to establish and cost effective
- Business losses may be used to offset other sources of income, which may reduce personal income tax

Disadvantages

- Personally responsible for all debts – unlimited liability
- Limited ability to raise third party capital
- Need to be a generalist; no partners with unique skills
- Attracting high caliber employees may be difficult
- There may be higher insurance costs to reduce the risk of unlimited liability
- No tax deferral available when earning active business income
- Cannot benefit from the Lifetime Capital Gains Exemption (LCGE) upon the sale of the business

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Partnership

A partnership is an arrangement in which two or more individuals combine resources with a view towards sharing expenses and profits. Generally, there are two types of partnerships – general partnerships and limited partnerships. In a general partnership, the partners share in the management of the business and each is personally liable for all debts and liabilities. Limited partnerships limit the liability of each partner to the amount that partner has invested in the business. Limited partners are not personally liable for debts of the business but are prohibited from participating in the day-to-day management.

It tends to be less costly to establish a partnership than a corporation because there are generally less government reporting requirements. Annual information returns are normally required for tax purposes, but income or losses of the partnership are reported on the personal tax returns of the partners.

One of the greatest advantages of a partnership is the ability to share in the unique skills and financial resources of the partners. A significant disadvantage, however, in the case of general partnerships, is that each partner is personally liable not only for their own business debts, but for those of all partners in the partnership. A partnership can also be difficult to dissolve should disagreements arise between partners. Having said that, establishing a Partnership Agreement at the beginning of the relationship can set operating guidelines and address the process for resolving disagreements for the benefit of all partners.

Advantages

- Personal liability would not fall to one partner – liability shared amongst general partners
- Can benefit from unique skills of partners
- Simple to establish; less costly than corporations
- Combined financial resources of partners
- High caliber employees can be made partners
- Business losses may be used to offset other sources of income, which may reduce personal income tax

Disadvantages

- Decision making is shared; potential for disputes
- Unlimited personal liability; one partner's liability may detrimentally affect all general partners
- Limited ability to raise third party capital
- Finding suitable partners may be challenging
- Can be legally bound by partners; difficult to dissolve partnership-partnership dissolves on death of a partner

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Corporation

A corporation is another common business structure. Unlike proprietorships and partnerships, the law considers a corporation an entity that is separate from its owners (i.e. shareholders). In fact, corporations file their own tax returns independent of individual shareholders, and corporate losses cannot be used to offset income on their personal income tax returns.

Ownership in a corporation can be easily changed through the purchase and sale of shares, without impacting the operations of the corporation's business. In regards to commercial activities, corporations have the same rights as individuals – they can sue, be sued, own and sell property.

It can be easier to raise capital for a corporation than for a sole proprietorship or partnership, due to the ability to issue shares. Shareholders also have limited liability – they are generally not personally liable for debts and obligations of the corporation.

You, as shareholder of your corporation also have some unique tax benefits including reduced tax rates for business income earned in the corporation, a possible tax deferral, and an exemption from capital gains tax when shares are sold that meet specific criteria. Corporations also allow for sophisticated retirement planning including the use of Individual Pension Plans (IPPs), Retirement Compensation Arrangements (RCAs) and Estate Freezes.

The main disadvantage of the corporate structure is cost. Corporations are complex and thus tend to be expensive to set up and operate. Depending on where your corporation resides, additional federal/provincial (territory) incorporations or registrations may be required, with resulting legal and accounting fees. In addition, corporations are heavily regulated, and require a number of reporting and disclosures such as detailed financial statements and tax filings.

Corporations can be public (traded on a stock exchange) or private. They might be classified as "professional corporations" if, as is the case with most doctors, dentists and lawyers in certain provinces/ territories, the activities of the business are governed by a professional association which permits the professional to operate through a corporation.

Advantages

- Separate legal entity; rights similar to individuals
- Creditor protection - personal assets are protected from business creditors (subject to some exceptions)
- Easier to raise third party capital through issuance of shares
- Tax deferral on retained business profits
- Possible tax savings on sale or at death (i.e., LCGE, and reduction of estate administration fees by use of secondary will)
- Greater flexibility in choosing remuneration and timing of tax liability (i.e., choosing salary/bonus and / or dividends as compensation)

Disadvantages

- Costly to start and maintain (closely regulated by governments)
- Possible conflict between shareholders and directors; can restrict decision making
- Directors could be held liable
- Personal guarantees can undermine limited liability
- Certain income earned through a corporation may be taxed at higher rates than if earned personally (depends on province/territory of residence)
- Double taxation can apply at death if post-mortem tax plan not considered

Should you incorporate your business?

Many businesses start out as a sole proprietorship or partnership and later become incorporated as the business grows and becomes profitable. Whether or not your business should incorporate depends on many factors.

If one or more of the following describes your situation, incorporating your business may be a suitable option.

The potential for liability is significant

If your business has the potential for significant liability, incorporating can help protect you and your assets. With a sole proprietorship or partnership, you are personally responsible for all debts and liabilities of the business. Whereas the liability of an individual shareholder is usually limited to the amount invested in the company. Of course, shareholders who provide personal guarantees of corporate debt (possibly for the purpose of securing a loan for the corporation), would be personally liable for the guaranteed amount. Directors and officers of a corporation can, in certain circumstances, be held personally liable for activities of the corporation.

My business is seeking capital

If your business needs to raise capital, incorporating can make it easier to do so. While corporations can borrow and incur debt like sole proprietorships, they can also issue shares to raise money that can be used in the business. This is a big advantage as equity capital does not have to be repaid and incurs no interest (although, your percentage of ownership in the company would decrease). Also, some lenders view corporations as being more stable than sole proprietorships, which can help to secure business loans.

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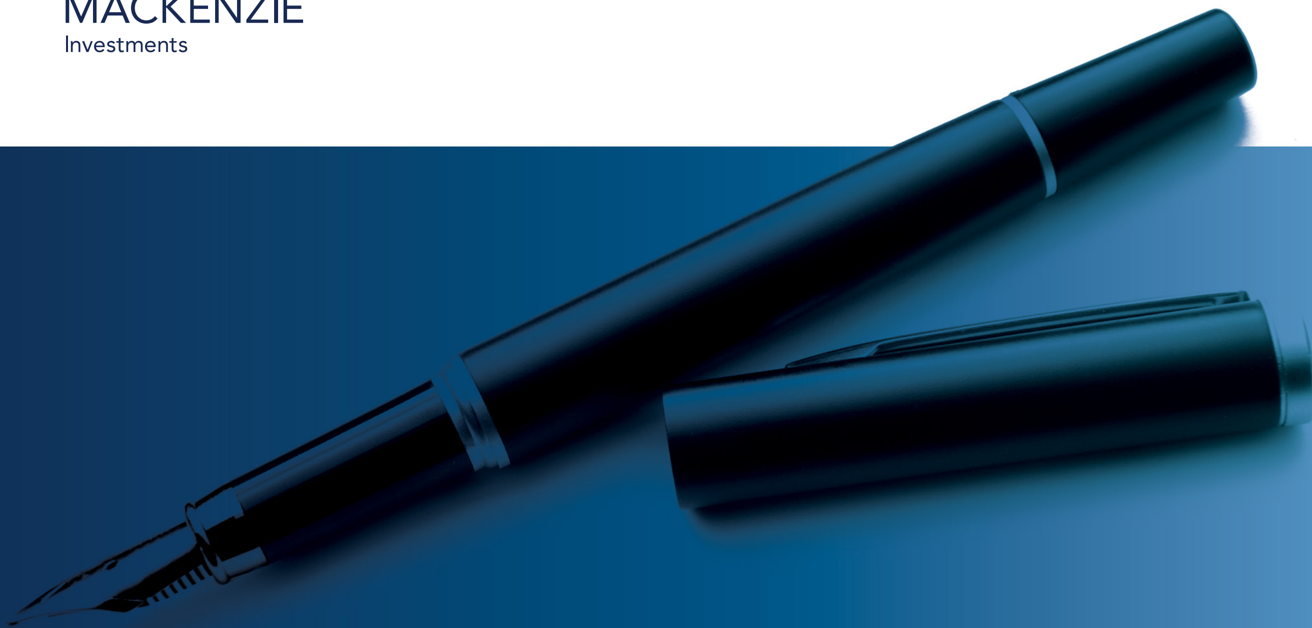

I don't spend all of my income

If you do not require all the business income for regular living expenses, then you may be able to take advantage of a tax deferral by earning your business income through a corporation. Generally, when income is earned through a corporation, it is taxed twice. Once at the corporate level, and again at the personal level when paid to individual shareholders as a dividend. When combined, the tax liability on business income earned through a corporation and distributed to individual shareholders is roughly equal to what the income tax would otherwise be if earned through a sole proprietorship, this is the concept of "integration". If you do not require all of your business income to fund daily living expenses, then the profits can be retained in the corporation and be subject to the first layer of tax (corporate tax), deferring the personal income tax to when a dividend is paid to you personally. Note, this deferral opportunity applies only to active business income. Investment income is taxed differently and does not offer a tax deferral.

The taxation of income in a corporation (including investment income) is discussed in more detail in Part 2: Earning Income in a Corporation.

I want flexibility with tax reporting

While sole proprietorships are required to use a calendar year-end (i.e. December 31st), corporations can choose any date as their fiscal year-end as long as the year does not exceed 53 weeks (Note: certain professional corporations are restricted to a calendar year-end). This allows flexibility in choosing a year-end that is most desirable for the business to help ensure that tax filing deadlines do not coincide with busy income earning periods. Also, certain corporate expenses can be claimed as a deduction prior to payment of the expense, resulting in a tax deferral. For example, bonuses accrued can be paid to employees up to six months after the corporate year-end. This allows corporations with a late fiscal year-end (i.e. July or later) to report and deduct the bonus on its current corporate tax return while deferring payment of the bonus and taxation to employees to the following calendar year.

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I have a spouse / common law partner (CLP) and/or adult children

Sole proprietorships, partnerships and corporations allow tax-deductible payments of reasonable salaries for services rendered by family members. Additionally, corporations allow the business owner to pay taxable dividends to family members, provided they are shareholders. If your spouse/CLP or adult child are in a lower tax bracket, the payment of dividends can result in tax savings for the family, provided they add valuable contributions to the business. Dividends paid to minor children are subject to the "Tax on Split Income" (TOSI) rules, which can apply top personal tax rates on taxable dividends received by minor shareholders, eliminating the possibility of income splitting. In addition, effective for tax years 2018 and beyond, taxable dividends paid to adult family members may also be subject to TOSI, unless certain exclusions are met. For example, dividends may be paid to adult family members who make meaningful contributions to the business. Tax savings are available if the adult family member is in a lower tax bracket. There are a number of exclusions available to incorporated business owners to income split between related family member shareholders.

For more information please refer to Mackenzie's whitepaper, The New Income Sprinkling Rules for Private Corporations.

I want to minimize tax on the sale of my active business corporation shares

The LCGE is available to individual shareholders when they sell "Qualified Small Business Corporation" (QSBC) shares. The exemption eliminates the first $892,218 (2021) of capital gains realized on the share sale. The exemption is only available to individuals on the sale of shares (not assets unless considered qualified farm property), it is not available to sole proprietorships or partnerships unless they incorporate their business. To be eligible, the shares must satisfy certain conditions.

More information is available in Part 3: Pre-Retirement Planning for Incorporated Business Owners.

I want to reduce taxes and other fees upon my death

When an individual shareholder of a private corporation passes away, they are deemed to dispose of their shares at fair market value at that time. While the LCGE can be utilized at death to reduce taxes in many situations, there could be unforeseen tax consequences in some situations. It is best to work with your financial advisor and accountant as part of your overall plan. More information is available in Part 5: Minimizing Double Taxation After Death.

In addition to income taxes, provincial/territorial estate administration fees (i.e., probate fees) could apply upon death. These fees are based on the value of your estate. On the death of a sole proprietor, the value of the business assets is included as part of the estate for probate purposes, which would generally exclude the value of any unsecured debt. On the death of an individual shareholder, the fair market value of the shares is used to calculate probate fees. This value adjusts for all debts (secured and unsecured) of the corporation including corporate taxes owing, and therefore probate fees may be lower for an individual shareholder. In some provinces / territories, there might be an opportunity to minimize probate fees on the value of private company shares if a properly structured secondary will is established or the shares are held in certain trusts. Speak to your lawyer about whether a secondary will may be beneficial.

More information is available in Part 4: Estate Planning for Incorporated Business Owners.

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I need to preserve income-sensitive benefits

If you are receiving government benefits that depend on your level of income (e.g. Old Age Security), earning income through a corporation can preserve these benefits. Incorporated business owners can defer the payment of dividends (or reduce their salary), allowing assets to remain in the corporation while minimizing the amount of taxable income paid to the individual shareholder. Planning ahead to structure your income in the most tax-efficient manner can be done each taxation year as your circumstances change so you can take best advantage of your cash flow and income tested benefits.

I'm thinking ahead to retirement

For incorporated business owners who are seeking advanced retirement planning strategies, an Individual Pension Plan (IPP) or Retirement Compensation Arrangement (RCA) can help supplement retirement income. The establishment of these plans require corporate funding that is tax deductible. IPPs and RCAs are not available to sole proprietors or partners.

These are discussed in greater detail in Part 3: Pre-Retirement Planning for Business Owners

While there are many advantages to incorporating, there are also some disadvantages. Business owners should consider increased legal, accounting and administrative costs of setting up and maintaining a corporation. Also, once your business incorporates, you as an individual shareholder will no longer have the ability to deduct business losses derived in the corporation against personal income (Note: corporate business losses can be used to offset income in the corporation for the previous three years or carried forward for twenty years). Because businesses often realize net losses in their first few years, many businesses begin as sole proprietorships or partnerships and convert to corporations as their business grows and becomes consistently profitable.

One should also be mindful of "Personal Services Business" (PSB) rules. These rules suggest that if, in the eyes of the Canada Revenue Agency (CRA), a business owner is considered an "employee" of the third-party entity to which he/she provides services, incorporating would deem the business owner to be an "incorporated employee" of that entity. Where this occurs, certain tax benefits typically available to corporations would not be available. To avoid the PSB rules and maximize tax benefits available when incorporating, the relationship between business owners and their clients should resemble a client-contractor situation and not an employer-employee situation.

Speak with your financial advisor, lawyer and accountant to determine if incorporating is right for you.

Choosing an appropriate business structure that meets your needs is an important decision and will depend on the specifics of your situation. Professional financial, legal and accounting assistance is recommended.

Part 2 of the Tax and Estate Planning for Business Owners Kit assumes you have incorporated your business and reviews the taxation of business and investment income through your business, and provides strategies for building wealth tax efficiently in your corporation.

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