**Tax Implications of Using a Corporation**

This summary is intended to provide a general overview of the significant Canadian tax implications of using a corporation to carry on business. Given that the commercial laws governing corporations are different in each province and the tax rates for each individual may be different depending on the individual’s particular situation, an individual considering incorporating business should consult with their own legal and tax advisors to determine if they are able to benefit from a corporate structure.

**Tax Benefits of Incorporation**

In general an Agent (Agent, “individual” or “owner”) would not consider incorporating a company to carry on their business unless they can leave after tax corporate income in the corporation. If the individual requires all the income they earn from their business to fund their living expenses, the tax deferral advantage of incorporating their business will likely be substantially eliminated.

In assessing the benefits of incorporation the following four items represent the most significant tax benefits of incorporation:

1. **Deferral of Income – The use of higher after tax dollars to finance operations and earn income**
2. **Tax savings – Flexibility of the type and timing of Income**
3. **Tax savings – Income Splitting**
4. **Tax savings – Lifetime capital gains exemption on a subsequent sale of shares**

A discussion of these benefits, tax integration and other considerations follows.

1. **Deferral of Income – The Use of higher after tax dollars to finance operations and earn income**

A significant benefit of incorporating a business is the deferral of income tax where the Agent is able to leave after tax income in the corporation to fund activities such as renovation and equipment purchases and funding the payment of expenditures, for example, meals and entertainment expenses.

The first $500,000 of active business income earned in the year by a Canadian-controlled private corporation (“CCPC”) is eligible for the “small business deduction” where such income is taxed at a lower corporate tax rate, which in Ontario is 15.5% for 2013 (significantly lower than the top marginal rate for an individual which in Ontario is 49.53% for 2013). This results in additional cash in the corporation as compared to the situation where the income was earned personally. By way of example at the tax rates noted above, if a corporation earned $150,000 and the individual needed $100,000 in salary, this would leave $50,000 of income in the corporation which at a tax rate of 15.5% would leave $42,250 of cash to fund activities within the business. If the individual took the $50,000 by way of salary they would net $25,235. Accordingly, in this example the individual would have $17,051 more cash working for them inside the corporation.

It is important to note that when the individual withdraws the after-tax funds left in the corporation as a dividend at a later date there may be a slight income tax savings or tax cost on
the overall taxes paid on the initial income earned (See Tax Integration). In other words the total taxes paid on the $150,000 earned in the above example will be approximately the same whether paid up front or after a dividend of the after-tax income is paid, the benefit comes from having more money working inside the corporation to generate higher income.

See Schedule A for an example of the deferral of income tax in a corporation

2. Tax savings – Flexibility of type and timing of Income

A corporation can determine the appropriate amount of salary and dividends to pay the individual which are subject to different rates of tax and planning considerations (i.e., pay a salary to maximize RRSP and CPP contributions and benefit from personal exemptions).

In addition, the timing of a dividend payment may be controlled such that the dividends can be paid at a time when the individual’s marginal rate is lower. In addition, withholding taxes must be remitted when salary is paid and tax on dividends must be paid on or before April 30th of the following year, but could result in the individual being required to pay tax instalments in the following year.

Accordingly, tax planning opportunities may exist by determining the appropriate mix of salaries and dividends for a particular individual.

3. Tax savings – Income Splitting

In some provinces a corporation may issue shares to family members such as adult children (or a trust for family members) that allow dividends to be paid to the family members so that income can be split among the family. To the extent that the family member who receives dividends from the corporation is subject to a marginal income tax rate lower than the owner it would result in a lower overall family income tax liability. When considering income splitting strategy, a number of issues should be taken into account:

a “Kiddie tax” – dividend income received by a minor child from a corporation may be subject to kiddie tax which imposes a higher rate of income tax on minor children on certain types of income. Accordingly, this income splitting strategy would generally only be available once the child reaches the age of 18.

b Attribution rules – where a corporation has a family member shareholder who is the spouse or minor child of the owner, the attribution rules must be carefully reviewed. The attribution rules can be complex. The attribution rules could attribute income back to the owner under certain circumstances, for example, where the owner gifts or loans property to his or her spouse or to a minor child to buy shares of the corporation. Further, the corporate attribution rules may apply where the owner transfers property (including the business) to the corporation and the owner’s spouse and/or minor children are shareholders of the corporation.

c Reasonable expense rule – A corporation may also pay a salary to a family member that may be taxed at a lower rate marginal tax rate. However, the family member must provide services
to the corporation in exchange for the salary and the amount of salary should be reasonable in the circumstances.

4. Tax savings – Lifetime capital gains exemption (“CGE”)

Capital gains on the future sale of the shares in a corporation may be sheltered from tax by the lifetime capital gains exemption (currently $750,000 for 2013 and increasing to $800,000 effective January 1, 2014) where the shares are qualified small business corporation (“QSBC”) shares at the time of disposition. One of the requirements for shares to qualify for the exemption is that all or substantially all of the assets of the corporation must be used in an “active business income” carried on primarily in Canada.

If one of the purposes of incorporating is to invest the accumulated corporate income inside the corporation, there could be substantial non-business assets in the corporation, which could result in the shares of the corporation not being able to meet the conditions to be shares of a QSBC.

Tax Integration

There may be a slight tax savings or tax cost of earning business income through a corporation followed by a distribution of all of the after-tax corporate income to the individual as dividends. This may occur because the combined corporate level of tax and the personal tax on dividends may be slightly higher or slightly lower that the personal tax if the income were earned by the individual directly, depending on their marginal tax rate.

a Schedule B provides an example of the combined corporate and personal level tax when the income is earned by a corporation and the after-tax income is fully distributed to the individual based on a set of highly simplified facts where the individual is subject to the highest marginal tax rate of 49.53% as a result of other sources of income.

b Schedule C provides another example of Tax Integration for an individual with business income of $150,000. In Scenario 1 the full $150,000 is paid in the form of salary, while in Scenario 2 $100,000 is paid in the form of salary and the remaining $50,000 is taxed in the corporation and the after-tax money is fully distributed to the individual as a dividend.

c All calculations must be reviewed in detail with an individual with appropriate tax knowledge before any structure is implemented.

Other Considerations

1. Administrative cost
   Setting up a corporation will result in a one-time set up cost. Further, there will be on-going annual administrative cost for tax, accounting and legal filing, which for a simple corporation could start at $5,000 per annum.
2. Administrative burden
   With a Corporation comes on going compliance with regulatory (i.e., Real Estate Council and Boards ...), corporate income taxes, commodity taxes and payroll taxes including the associated audits and reporting.

3. Investment Income
   Any investment income earned by the corporation from the retained income is taxed at tax rates that approximate the tax rates that would be applicable if the investment income was earned directly by the individual with a marginal tax rate in the highest tax bracket.

   If one of the purposes of incorporating is to invest the accumulated corporate income inside the corporation, there could be substantial non-business assets in the corporation which may eliminate access to the CGE.

4. Other technical issues
   a. Personal services business rule – consideration should be given to ensuring that the personal services rule (i.e., the incorporated employee rule) does not apply. These rules would deny the corporation access to the small business deduction and to deductions other than those directly related to the compensation of the incorporated employee.

   b. Association rules – the association rules require associated corporations to share the $500,000 small business deduction limit. If the individual’s family owns other corporations carrying on an active business, these rules should be considered.

   c. Alternative structures – An individual may consider using another holding company or trust in addition to the corporation that will own their business. There may be benefits of using these additional entities.

   d. Real Estate Regulations – the Real Estate regulator may have rules or regulations in place which may preclude accessing certain tax structures and associated tax benefits and/or making doing so very time consuming and expensive i.e., Real Estate Agents are not permitted to carry on a real estate business through a corporation in the Province of Ontario, and accordingly to access the benefits of a corporation the Agent would need to set up, license and operate their own real estate brokerage operation.

Summary

Incorporating a business can provide a significant benefit for an individual, in particular where the individual can retain income in the corporation. There are however various costs and complex technical issues to consider when incorporating a business and as such may not be appropriate for everyone. An individual considering incorporating a business should
consult with their own legal and tax advisors to determine if they are able to benefit from a corporate structure given their particular circumstances.