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When is the **Right Time** *to Incorporate* Your **Proprietorship?**



There are many points to consider when pondering the decision of whether or not you should incorporate your business.

It can be a costly mistake if you incorporate “too early”; it is not a change you should make without consulting a tax professional and considering all the implications.

The following paragraphs address just a few of the tax implications you should consider when making this decision.

Do You Expect Losses or Income?

It is not uncommon for a new business to incur losses for the first few years. A proprietor who realizes these losses may generally claim them against any other source of income, thereby reducing his/her total personal tax liability. If an incorporated business realizes these losses, however, they are not deductible against the proprietor’s personal income. Rather, they may only be used by the company so they may not be of any immediate benefit.

As a result, you may in certain circumstances wish to delay incorporating your business until sufficient income is expected to be earned.

Income Splitting

A proprietor may pay a spouse a reasonable wage for services provided. What may be considered “reasonable,” however, is subject to interpretation. A corporation may also pay a reasonable wage to an owner’s spouse.

Further income splitting may be achievable via the payment of dividends. The simplest scenario to describe this possibility occurs when a business is starting up and has no assets or value at that time.

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A spouse may purchase shares upon incorporation (with the spouse’s own funds) and in the future, when the company becomes profitable, income may thereby be “split” via the payment of dividends based on the shares held.

When companies are used to operate a business, it is also not uncommon to consider the use of a family trust to hold some shares. Many rules are now in place, however, that limit the opportunity to involve minor children. Such rules and restrictions must be carefully

considered before implementing a plan that may involve a trust and/or minors.

Can Taxes Be Saved or Deferred?

It is not uncommon for clients to ask the question, “Will I pay less tax if I incorporate a company?” In this regard, it has long been part of the Canadian tax system to permit a lower tax rate for qualifying Canadian controlled private corporations on their active business income. In BC for 2006, this lower corporate tax rate was approximately 17.6 percent on the first \$300,000 of active business income reported in the year. (This rate can be much more attractive than the top 2006 personal rate in BC of approximately 43.7 percent.) So, in fact, it may be tax-beneficial to incorporate in some circumstances.

The decision to incorporate, however, is much more complex than this and should involve much more analysis. It is also possible for you to incorporate “too early” even when incorporation, in general, is a good idea in the particular circumstances.

For example, if you incorporate to take advantage of lower corporate tax rates, but still need to draw out all the earnings of the company as wages, there may be no income left to be taxed in the company; the shareholder would still be taxed on his/her wages at the higher personal rates!

Further, additional compliance costs related to incorporation would also be incurred, i.e., year end accounting fees, annual legal filings, etc. As such, you must be careful not to incorporate too early because expected tax benefits may not materialize!

If income is earned by the company and taxed at a lower corporate rate, the after-tax earnings can be reinvested in the business or may be paid out as dividends to shareholders. To the extent dividends are paid shortly after the income is earned by the company, however, any potential tax advantage can be virtually eliminated. In these circumstances, due to the way such dividends are taxed to individuals, approximately the same amount of tax may result to the individual shareholder as would result if he/she earned the business income through his or her proprietorship.

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This result will depend, of course, on the prevailing federal and provincial tax rates. For this reason, the lower corporate tax rate available to certain corporations may result in more of a tax deferral than a tax savings—so incorporation may not always deliver what you expect!

The Capital Gains Exemption

If you have plans to sell your business, you may be able to shelter up to \$500,000 of your resulting capital gain. This capital gains exemption (CGE), however, is only available for the sale of eligible shares of a qualified small business corporation that are held by an individual; it is not available to shelter any gain on the sale of a proprietorship. Various criteria must also be met from both the corporate and personal perspectives before the gain may be considered eligible for the CGE and the CGE available to the

shareholder. If available, however, substantial tax savings can result that would not be available to a proprietor making a similar sale.

Other Incentives to Incorporation

Various provinces may offer incentives for incorporation, such as tax credits for companies earning certain types of income or for purchases of certain types of assets. Further, if a company undertakes activities that qualify for tax purposes as scientific research and development (SR&D), tax breaks may be available, that is, the investment tax credit for eligible SR&D expenditures of qualifying Canadian controlled private corporations is 35 percent vs. no more than 20 percent that may be available to an individual.

Such incentives may provide reason to consider incorporation and to consider in which province you may wish to incorporate.

Caution!

This article provides just a few ideas that may be available, although many other planning opportunities—some of them being much more complex!—should also be considered in light of your individual and business circumstances.

Ongoing changes in the tax system also make it necessary to check current rules before plans are put into motion. Much of the information available today, including information in this article, is based on legislation that may have changed since the time of writing.

It is strongly recommended that anyone contemplating incorporation of a business or considering any of the tax planning strategies mentioned above first seek appropriate professional advice.

Thorough consideration must be given to your own specific circumstances, nontax issues relating to incorporation, and to the current prevailing tax legislation. ▲

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