To incorporate or not to incorporate… that is the question?

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"As the owner of a sole proprietorship, there comes the time when it may make sense to consider incorporating."

As the owner of a sole proprietorship, there comes the time when it may make sense to consider incorporating. Many owners become interested after reading something about it or hearing people talk about incorporating. This article highlights some of the issues to consider on whether you should incorporate an active business or not.

TAX PLANNING CONSIDERATIONS:

Is the business profitable? Generally in the first few years of operation, a business will generate losses due to high start up costs and/or not having many clients. If a business is held personally, the losses can be deducted against all other sources of income assuming the business is not a personal endeavor (Stewart 'Reasonable Expectation of Profit' Supreme Court case).

If a business is incorporated, losses can only be applied against corporate income and carried back three years or forward for seven years (Note: the 2004 federal budget proposed to increase the carryforward to ten years. At the time of writing, this legislation was still not passed) before they expire worthless. However incorporated business losses cannot be used to offset personal income.

Is the business producing more income than the proprietor needs? If so, then incorporating may allow for income splitting (ie: dividends paid to other adult family shareholders) and tax deferral opportunities due to the small business deduction (see below). Little or no benefit would be gained by paying all the profits of the company, via salary or dividends, to the owner-manager.

Does a corporation really pay lower taxes? In recognition of

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small businesses being significant contributors to economic growth and job creation, small businesses enjoy a greatly reduced tax rate on the first $300,000 of **active** business income due to the small business deduction. The goal is to decrease the tax burden for small businesses, which in turn frees up their capital for reinvestment resulting in greater economic opportunity and job creation. The Small Business Deduction is not available on investment income earned in a corporation.

The Small Business Deduction: To illustrate, the combined federal and provincial tax rates that businesses are charged is about 20% on the first $300,000 of income. Personal Tax rates are up to 48% on taxable income over $115,000. This allows an incorporated business to reinvest more capital into growth. However, this is only a deferral as when the funds are ultimately paid out of the corporation, either by way of dividend or salary, full income tax at personal rates will be paid.

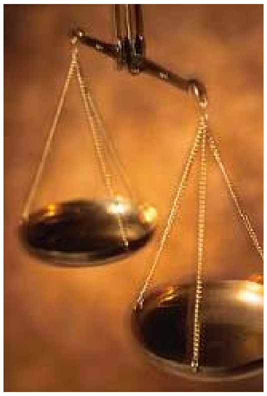
Is retiring or succession planning being considered? If either is being contemplated for several years down the road, incorporating can reduce or defer the taxes that would otherwise be payable. Two common methods are:

Arrange the business affairs so that it qualifies as a small business corporation. A portion of any gain on the sale of the shares could be exempt from tax by way of the capital gain deduction. By using this deduction, up to $500,000 of Capital Gains can be sheltered.

The $500,000 capital gain exemption not available if a sole proprietor sells assets of the business. However, it is possible for a sole proprietor, anticipating a sale, to incorporate immediately before a sale and then sell the shares of the corporation to be eligible for the $500,000 capital gains exemption.

Estate Freeze: This is a process whereby future growth of a company is transferred to other family members but control remains with the original owner. This process can have two main results: 1) transfer of future tax liability on the growth of the company and 2) multiply the use of the $500,000 Capital Gains Exemption for small business owners.

Expense Myth: Many people believe that you can write off many more different kinds of expenses if you incorporate your business. In fact, you are still limited to writing off those expenses that were incurred to produce the income. However, incorporation usually brings higher annual legal and accounting expenditures than a sole proprietorship.



OTHER CONSIDERATIONS:

Limited Liability: Since a corporation is viewed as a separate legal entity, the creditors of the corporation cannot generally seize the personal assets of the owner-manager unless the owner-manager gave personal guarantees for loans of the corporation.

Tax Holiday: In several provinces, newly incorporated business are offered up to 3 years of income or sales tax relief.

Non-Taxable Benefits: A corporation can offer benefits that are not available to sole proprietorship owners. Some examples are: Group disability and health insurance and registered pension plans.

Additional Costs: A corporation is required to file its own tax returns and hold annual shareholder meetings. This leads to higher administration, legal and accounting expenditures on an annual basis.

Capital Tax: Some corporations are required to pay a tax on the “taxable capital” of the corporation. As Capital Tax is not based on taxable profits, it is possible that a corporation will have a Capital Tax liability even if the company has losses in the current year. In basic terms, taxable capital is a corporation’s share capital, retained earnings, contributed surplus and most liabilities less specified eligible investments. If the assets are less than a specified threshold, then no Capital Tax is payable. The capital tax is being phased out and the thresholds are becoming quite high now so this won’t affect most people contemplating incorporating. Refer to the Bulletin article called “Capital Tax” for more information on capital tax and various exemptions.

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Note: The above information is based on the tax law in effect as of the date of this article. The article is for informational purposes only and should not be construed as offering tax or legal advice. Individuals should consult with a qualified tax and legal advisor before taking any action based upon the information contained in this article.