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In this article, Vern Krishna gives readers an overview of the Budget 2016 anti-avoidance rules that are already in effect, that will affect the way that professional corporation, or partnerships, obtain a tax deferral and notes that professional partnerships should review their arrangements to account for the new anti-avoidance rules.

Tax Deferral for Professional Corporations (Vern Krishna)

Date: November 14, 2016

Tax Deferral for Professional Corporations

By Vern Krishna

Special corporate and tax rules apply to professionals carrying on business. The rules are technical, but have attractive aspects if one uses them properly. There are substantial tax deferral savings available and, for some professionals, even opportunities for income splitting. Budget 2016, however, introduced special anti-avoidance rules to prevent professionals from undermining the tax incentives, and these should be factored into professional corporation structures, particularly those that involve partnerships.

A professional corporation (PC) allows professionals—such as, doctors, dentists, lawyers, and accountants—to provide their services to clients through a corporate entity, rather than personally. The corporate entity must be created under the auspices of provincial or territorial corporate statutes, and comply with rules determined by provincial regulatory bodies. The rules typically control the structure and operation of such entities to ensure that they do not violate, or circumvent, professional codes of conduct and practice.

There are principally two forms of tax incentives for small businesses: low rates of tax on business income, and integration of corporate and shareholder taxes. The low rates allow small businesses to accumulate capital. Tax integration prevents double taxation of the same income.

The tax is about 15% on the first $500,000 of active business income earned in Canada. Thereafter, the rate jumps to about 26.5% on income above that level.
The following table shows the relative tax treatment of individuals and private corporations carrying on an active business:

	Proprietorship	**Small business income up to $500K**	**Active business income above $500K**
Taxable income	$100,000	$100,000	$100,000
Corporate tax @ 15%	0	15,000	
Corporate tax @ 26.5%			$26,500

	Proprietorship	Small business income up to $500K	Active business income above $500K
Net income	$100,000	$85,000	$73,500
Personal tax on dividend @ 45.30%	0	$38,505	
Personal tax on dividend @ 39.34%			$28,915
Personal tax on income	$53,530	0	0
Net after-tax income	$46,470	$46,495	$44,585

The table shows that the tax payable on business income is nearly perfectly integrated where the corporation pays out all of its income as dividends to shareholders.

The real advantage of tax deferral, however, is where the corporation accumulates it income and does not pay it out immediately to its shareholders. In the above example, the personal tax on the dividends is payable only when the corporation pays the dividends. Until then, the tax thereon is deferred. The following table illustrates the power of compounding the deferred taxes at various rates over an extended period:

Annual tax savings in corporation	After tax yield	Years	Future value of savings
$10,000	3%	10	$114,639
$20,000	4%	20	$595,561
$30,000	5%	30	$1,993,165
$40,000	6%	40	$6,190,478

The deferral advantage, which depends upon the after-tax yield, magnifies the longer the funds are left in the corporation.

During the election, Justin Trudeau expressed displeasure with the low rate of tax and said that he would restrict its availability to higher income earners—presumably, the top 1 percent of society. Now that he is the Prime Minister, we can expect the Department of Finance to look, once again, at restricting the availability of the low tax rate and introduce a tiered model of business taxation, similar to that which his father introduced when he was Prime Minister, which denied the deduction to doctors, dentists, lawyers, accountants, chiropractors, and veterinarians. Budget 2016 did not act on the possible proposals, but did introduce anti-avoidance rules to curtail multiplying the small business limit for professionals in partnerships.

The low rate incentives have a cost. Hence, the system restricts the incentives to a manageable cost. The low rate of tax is available only to Canadian-controlled private corporations (CCPCs) that earn active business income (ABI) in Canada. However, the small business deduction is not confined to “small businesses”. It is available to all CCPCs on the first $500,000 of their ABI, which is what especially irks the Prime Minister. The benefit of the small business deduction is phased out for large CCPCs, but he would like to restrict it even further.

However, some partnerships structured their arrangements so that a shareholder of a CCPC would become a member of the partnership, which would then pay the CCPC as an independent contractor under a contract of services. Since the CCPC would not be a member of the partnership, it could claim the entire $500,000 business limit as a small business deduction on its ABI.

To prevent the above type of tax planning, Budget 2016 extends the specified partnership income rules (SPI) to structures in which a CCPC provides (directly or indirectly) services or property to a partnership during a taxation year of the CCPC where, at any time during the year, the CCPC or a shareholder of the CCPC is a member of the partnership or does not deal at arm's length with a member of the partnership.

The opportunities for tax deferral savings continue for professional corporations. However, professional partnerships will need to review their arrangements to account for the new anti-avoidance rules, which are already in effect.

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