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Corporate Tax Centre - In this article, Vern Krishna discusses taxation rules, concepts, and regulations of professional corporation taxation, and defines important concepts including Limited Liability Partnerships, liability, holding companies, and more.

The Regulation of Professional Corporations (Vern Krishna)

Date: September 8, 2015

 [The Regulation of 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 properly used. There are substantial tax savings available and, for some professionals, opportunities for income splitting. The corporate rules vary by province and territory. The tax rules are federal and apply across the board.

Roscoe Pound defined a professional as a person “pursuing a learned art as a common calling in the spirit of public service—no less a public service because it may incidentally be a means of livelihood.” Daniel Duman calls the English bar “the classic English profession as measured by nearly all the criteria usually associated with professionalism: autonomy from external interference, monopoly over practice, the possession of esoteric knowledge and skills, corporate unity and a position of dominance over a clientele dependent upon professional advice.”

For tax purposes, the definition of a “professional” is much broader than any of the traditional professions (lawyers, doctors, accountants, engineers, architects, etc.), and includes almost any occupation other than individuals who engage in a personal services business as an “incorporated employee”. Thus, with the limited exception for incorporated employees, almost any individual can form a professional corporation for tax purposes. There are, however, also stringent regulatory rules in each of the provinces.

A professional corporation (PC) allows professionals—such as, doctors, dentists, lawyers, and accountants—to service clients through a corporate entity created under provincial or territorial corporate statutes. The PC rules are intended to level the playing field for professionals so that they can operate in the same way as other individuals. However, there is one significant difference between professionals and non-professionals: Shareholders of PCs cannot limit their liability for negligence or malpractice, and they remain jointly and severally liable for all professional liability claims against them. This makes the choice of form of practice an important decision.

Large law and accounting partnerships are usually better off practicing as limited liability partnerships (LLPs) in order to limit the personal malpractice exposure of their partners. On the other hand, sole proprietors, and small partnerships of two to four partners, may be better off practicing as PCs for the tax advantages.

Fundamental Business Concepts

The fundamental business structure of a professional corporation (PC) is that the corporate entity provides its services through an employee, who may also be its principal shareholder. The principal business imperative of a professional service

corporation is that the entity must provide the services to, and contract with, the client or third party, even though it is the professional who personally delivers the service. Thus, the professional is the agent of the corporation. The corporation cannot be the agent of the professional.

A professional corporation should conduct itself as in the case of any other business corporation. This means that it is the PC that should:

- Enter into all contracts, including employment contracts;
- Enter into leases and contracts to acquire services;
- Operate its bank accounts;
- Promote itself in advertising; and
- Prepare financial statements.

In essence, the PC must deliver the services.

Enabling Statutes

Professionals can incorporate in all Canadian common law provinces under their respective corporate statutes. In Ontario, for example, the Business Corporations Act, is the governing statute for PCs.

Section 3.1 OBCA provides that:

Where the practice of a profession is governed by an Act, a professional corporation may practise the profession if,

(a) that Act expressly permits the practice of the profession by a corporation and subject to the provisions of that Act; or

(b) the profession is governed by an Act named in Schedule 1 of the *Regulated Health Professions Act, 1991*, one of the following Acts or a prescribed Act:

1. *Certified General Accountants Act, 2010*.
2. *Chartered Accountants Act, 2010*.
3. *Law Society Act*.
4. *Social Work and Social Service Work Act, 1998*.
5. *Veterinarians Act, 2000, c. 42*.

After some initial resistance, all of the common law provinces now allow lawyers to practice their profession through PCs.

With the exception of physicians and dentists, where special rules apply, subsection the OBCA effectively precludes most other professions from splitting their professional income with family members who are not also members of the same profession. Thus, the rule prevents most lawyers from taking advantage of one of the principal tax benefits of private corporations.

Void Voting Agreements

Voting agreements that vest powers or proxies in non-members of the profession are void if they remove powers from the shareholder, as are unanimous shareholders agreements if all of the shareholders are not members of the PC.

Continued Existence of Corporation

The OBCA, for example, provides for the continued existence of a PC despite:

- (a) the death of a shareholder;
- (b) the divorce of a shareholder;
- (c) the bankruptcy or insolvency of the corporation;
- (d) the suspension of the corporation's certificate of authorization or other authorizing document; or
- (e) the occurrence of such other event or the existence of such other circumstance as may be prescribed.

Unlimited Liability

A professional practicing his or her profession through a PC cannot limit his or her liability. Thus, the liability of a professional is not affected by the fact that the member is practicing his or her profession through a PC. The member is jointly and severally liable with his PC for all professional liability claims in respect of errors and omissions made during the tenure of his shareholding in the corporation.

Limited Liability Partnerships

The liability of a shareholder of a PC that is a partner in a partnership is not affected by the existence of the PC structure. Thus, where a PC is a partner in a partnership, or limited liability partnership, the shareholders of the PC continue to have the same liability in respect of the partnership, or limited liability partnership, as they would have if they were directly the partners.

Regulatory Restrictions

A PC cannot carry on any business other than the practice of the profession of its shareholders. All of the shareholders of the PC must be members of the same profession: lawyers in the case of law firms, accountants in the case of accounting firms, etc. There can be no multi-disciplinary practices in a PC. A PC may, however, carry on any ancillary activities and can invest its surplus funds, including any cash saved from its deferred tax. Professional regulators also stipulate various requirements and procedures to follow for PCs. For example, the Law Society of Upper Canada provides as follows:

Accounting for PCs

A PC carrying on a business is generally taxable on its income on an accrual basis. However, lawyers (but not paralegals), accountants, dentists, medical doctors, veterinarians, and chiropractors can elect to exclude any work in progress from their income at the end of the year.

This benefit also extends to their PCs.

Tax Deferral

For most professionals, the most compelling reason for incorporating is to benefit from the tax advantages available to corporations. The principal tax advantage from a PC is tax deferral. The difference between the tax payable by incorporated and unincorporated professional practices is significant. Individuals pay tax on their business income at progressive marginal tax rates. In 2015, the top combined federal/provincial marginal tax rate is about 49.53 per cent in Ontario (45.80% in B.C.; 39% in Alberta) starting at an income level of approximately \$138,586. In contrast, the federal corporate rate of tax is about 11 per cent (approximately 15 per cent combined federal and provincial rates) on the first \$500,000 of professional business

income. The (approx.) 35 percent point spread allows professionals to defer tax if they leave their income in the corporation. Since partners must share the \$500,000 limit between themselves, the full benefits of incorporation accrue only to sole practitioners and small partnerships.

In the April 21, 2015 Budget, the federal finance minister announced reductions in the small business tax rates from 11% to 9% over a four-year period. Hence, it will become even more advantageous to defer taxes in the future. As a consequence of the proposed reductions, the personal gross-up factor and dividend tax credit for ordinary (non-eligible) dividends will be also be adjusted. Alberta, New Brunswick, Nova Scotia, and Yukon announced changes as of May 15, 2015, but have not announced changes to their DTC rates as a result of the federal changes.

Tax deferral is a real and substantial tax saving, which can accumulate into very significant amounts in the end. The magnitude of any deferral depends upon the reinvestment rate and the length of time that the entity accumulates its income. Thus, professionals can use tax deferral as a surrogate pension plan.

Example

Assume that Nancy, age 35, manages to save \$1,000 annually for 30 years in her PC, which, after tax, the corporation invests in securities that generate 10 per cent per year. After 30 years, Nancy extracts all of the corporation's accumulated investment profits and pays personal tax on the dividends at her top marginal rate at that time. If her net rate of tax after the dividend tax credit is 30 per cent, she will earn \$4,026 more through her corporation than she would have earned personally without her PC. The more she saves, the greater the tax deferral advantage. If she can save \$50,000 each year in the PC, the comparative advantage of incorporation grows to \$201,000.

Since tax deferral is the key to planning with a PC, one should clearly understand the mathematics of the time value of money and discount rates in advising clients on corporate structures. Without tax deferral, there is no advantage to a PC. Indeed, there are distinct disadvantages in the form of higher costs in maintaining and operating a corporation.

Remuneration

Incorporation also enhances remuneration flexibility, and allows a choice between receiving compensation as salary or dividends. For example, professionals may wish to receive sufficient salary income to allow them to contribute to a Registered Retirement Savings Plan (RRSP) and Canada Pension Plan (CPP). In other circumstances, an individual may prefer dividends if he has a cumulative net investment loss (CNIL) and wishes to claim the capital gains exemption. The costs of administration may, however, outweigh the tax advantages if the professional needs to extract all of the PC's business income in each year.

Holding Companies

Depending upon the applicable provincial legislation, professionals may be able to use a holding company (Holdco) to own the shares of a PC, and siphon off professional earnings to the holding company through tax-free dividends. This will reduce shareholder risk in the PC, and allow the saved cash to accumulate in Holdco. To be sure, there is no real risk in leaving surplus funds to be reinvested in the PC itself if the professional shareholder is fully and adequately insured against negligence. A Holdco, however, adds greater certainty to the structure.

There are opportunities in some provinces to split income between family members, but they should be structured only after careful consideration of the attribution rules, and the special tax (the "kiddie tax") on certain income that minors can earn from such structures.

The kiddie tax can neutralize the benefits of income splitting business income in corporations in which the parents are active.

Professional regulators sometimes restrict the use of holding companies. For example, the Law Society of Upper Canada states:

The ownership of shares in a holding company must be restricted to licensee(s). Shares in a holding company may not be owned by family members or non-licensees. In addition, the business of a holding company must be restricted to holding the shares of the professional corporation. Applicants who intend

to use a holding company must submit the Articles of Incorporation for the holding company along with their Application for a Certificate of Authorization.

Conclusion

PCs allow professional flexibility in arranging their business affairs for maximum after-tax retention of earnings. The corporate and tax rules allow professionals carrying on business substantial savings through tax deferral, and for medical professionals opportunities for income splitting. However, all professional corporations must comply with provincial corporate rules, the local rules of professional conduct, and, of course, the federal tax statute.

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