

Chapter 1

Incorporation 101

If you're reading this and you're not incorporated, you need to call your financial planner *right now* and ask them why they haven't recommended that you incorporate. One of my best friends is a very successful family doctor in Ontario. We made sure that as of day 1 in his career—before he'd even received his first Ontario Health Insurance Plan (OHIP) payment—his medical professional corporation was set up and properly structured. Over the course of his career, this single move has saved him hundreds of thousands of tax dollars. *So if you're a practicing professional, and you're not incorporated, why not?*

What You'll Get Out of This Chapter

This chapter covers the basics of incorporating for the professional and business owner, including a review of the process and costs to incorporate, as well as the likely benefits. We also review when incorporation may not be beneficial, and how buying a house meshes with your corporate structure.

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In this chapter, you'll learn about shareholder loans, the lifetime capital gains exemption, how a corporation can provide creditor protection, and what to do with your corporation when you transition into and through retirement.

Why Incorporate?

Here's the answer: the rationale for incorporation is the difference between paying income taxes at your personal rate, which can be as high as 53.53% (Ontario's highest marginal rate in 2020 after \$220,000 of income), or your corporate small business deduction (SBD) rate of 12.2% (Ontario's combined federal and provincial tax rate). But in addition to the (potentially substantial) tax benefits of incorporation, you will also get increased flexibility in choosing the government programs in which to participate and invest.

A good financial planner should acknowledge that they have absolutely no control of the markets. While we do all try our best to spot trends and mispricings, in some form or fashion, we are always riding along with the ebbs and flows of market movements.

Taxes, in contrast, we have complete control over (within the rules and parameters of the tax code). Taxes are factual, they are mathematics, they are "known knowns." This means that we can master and control them. While we cannot avoid them, we have the ability to plan and mitigate some taxes. In our financial lives, our focus should be on controlling the controllable—and the corporation is a powerful tool that allows us to control our tax bill.

What Does It Cost to Incorporate?

Setting up your professional corporation using a lawyer should cost you less than \$2,000—and less than \$1,000 if you take a

do-it-yourself approach. Organizing the corporation—issuing shares and creating by-laws and shareholder agreements, for example—can drive up costs, but keep in mind that you can deduct up to \$3,000 of costs related to incorporation. And while it's possible to incorporate using a DIY approach, consulting with a professional can help ensure that you're set up appropriately from the get-go.¹

To be frank, however, I view the cost of incorporation essentially as a “sunk cost” (a cost you have already incurred and cannot recover), as you will likely incur these organizational costs at some point in your career—the only question is when.

Also, in my conversations I always stress that you shouldn't be fooled by the myth that higher legal costs will produce better outcomes for your corporation. Incorporating is simple. The only “trick” to watch out for is ensuring you create enough classes of shareholders at the outset so your spouse (or future spouse) and/or your kids (or future kids) can all have shares—they each need to have a letter in front of their shares (Class A, Class B, and so on) so the corporation can pay them different amounts, if you like. That's the (only) “secret sauce” for your Articles of Incorporation. (With that said, if this issue has to be fixed later on, it can be, but your legal costs may be much higher.)

In general, your yearly corporate accounting fees might be in the range of \$1,000–2,500/year, and ongoing maintenance fees could be as high as \$500 (with a lawyer) or \$150 (if you file yourself). These fees can be much higher if there is significant active and passive income. Additionally, each year, you'll need to renew the certificate of authorization, and you'll also need to keep the corporation's minute book up to date.

What's the Process to Incorporate?

(If you're already incorporated, skip ahead to the section “How Does Purchasing a Home Fit into My Incorporation Timeline?”)

We all know time is money, and addressing the added complexity of a corporation will take some of your valuable personal time.

The good news, however, is that most of this extra time commitment is required only once, during the initial stages of incorporation.

The following is the basic process to incorporate.

Written Consent

In some provinces, it is required that written consent be obtained before you can license your corporation. Each province has its own rules and standard applications, which can be obtained from its appropriate provincial licensing body.

Articles of Incorporation

You will need to prepare a shareholder agreement and your articles of incorporation, usually using legal counsel. You will also need to establish a corporate bank account, advise your respective association (e.g., the Canadian Medical Protection Association (CMPA)) of your incorporation, and assign your medical services billing number to the corporation. (Professional corporations, as defined in section 248(1) of the Income Tax Act, must notify the relevant professional regulatory body of their incorporation.) You should also advise all employees, patients, suppliers, creditors, and insurers that you've incorporated your professional practice.

Payroll Remittances

Once you receive your Canada Revenue Agency business number, which will look something like 12345 6789 RP0001, the number for your corporate remittances will look something like 12345 6789 RC0001. (The two numbers will be identical, differentiated only by the RP, RT, or RC program accounts.) You do not need to make corporate remittances in the first year, but you are required to make payroll remittances. It is important to note that enrollment for payroll and/or HST accounts is not automatic—this is something your accountant will be able to help you with.

Employment Contracts

Upon incorporating, a new written contract will need to be created for the new employee/employer relationship you'll be entering into as an employee of your professional corporation. Additional contracts for your spouse, children, and any other employees will also need to be developed. Establishing written contracts may be important for future reasonability reviews, given the new tax on split income rules (more on that later).

Transferring Assets

When you incorporate, you should consult with your accountant and/or financial advisor about which assets, if any, need to be and/or should be transferred to the corporation. (Keep in mind you are, in fact, selling your practice to your corporation.)

You can transfer assets, including goodwill (an intangible asset that's made up of the value added by your reputation and customer lists to the value of your practice), tax-deferred to your corporation by filing an election with the Canada Revenue Agency—called a “section 85” election, as the rules are set out in section 85 of the Income Tax Act. This election will ensure you avoid having to pay taxes if the fair market value (FMV) of your assets exceeds their adjusted cost base (ACB).

While the greatest benefit of the section 85 election is to transfer eligible property on a tax-deferred basis (at the lower of cost or the undepreciated capital cost) to a taxable Canadian corporation, there is an opportunity to trigger a gain if it is beneficial to the individual's circumstances. Also, whether the transfer is tax-deferred or not, it is nevertheless a disposition and must be reported on the transferor's tax return.

Before you transfer any other assets to the corporation, such as real estate or insurance policies, a careful cost-benefit analysis should be carried out. The following are some high-level considerations.

Real Estate

An individual can simply sell an existing rental property to their corporation in exchange for assets or debt, but the sale would trigger any unrealized capital gains, as well as a possible recapture of any capital cost allowance previously claimed on the rental property in the hands of the individual.

An individual may also transfer personally held assets to a corporation on a tax-deferred basis by taking back shares (and possibly debt) of the corporation in exchange for the property. The value of the shares received would reflect the value of the property transferred to the corporation. Then, when the property is eventually sold by the corporation, any accrued capital gains would be taxable to the corporation and distributed to the shareholder, likely in the form of dividends.

There are other factors that would need to be considered as well before assets are transferred to the corporation. For example, in the case of real estate, you would be required to pay a land transfer tax if the property is not used for the active business of the corporation. While I have seen some lawyers work around these issues using a trust structure, it's best to assume these taxes are to be paid. It is also important to determine whether the goods and services or harmonized sales tax (GST or HST) applies.

It should be noted that some real estate transactions do avoid land transfer taxes. These include gifts for no consideration (including no assumption of a mortgage). Although the tax is triggered and a tax return should be filed, as the tax is based on the consideration, the actual amount of the tax will be nil (as the consideration is also nil).

Insurance Policies

If you're thinking about transferring a personally held insurance policy to your corporation, you need to proceed with great care, specifically comparing:

- The corporate savings of the corporation paying the insurance premium (note that life insurance premiums are not

a deductible expense unless specifically required as part of collateral on debt) minus the income tax due on the cash surrender value (CSV) minus the adjusted cost base (ACB) at the transfer; and

- The cost of paying a lump-sum bonus this year so that, after personal income tax, you have enough remaining to pay the tax due on the taxable income.

While the March 2016 federal budget reduced the benefits of transferring insurance policies to a corporation, it recommended that consideration which is at least equal to the higher of the CSV and the ACB of the policy be paid. If this recommendation is implemented, the policy's new ACB will be the highest of the following amounts: the value of the policy (CSV), the fair market value of the consideration paid, and the ACB. This new ACB will affect the taxation of the insurance plan. If the policy is surrendered before death, there is a gain to the extent that the CSV exceeds the ACB. On death, any life insurance proceeds received, assuming the corporation is the beneficiary, are added to the CDA account, and can be paid out as a tax-free capital dividend.

Choosing Your Corporation's Year-End and Maintaining Your Corporate Records

Once you are incorporated, you will need to designate a fiscal year-end for your corporation. If you're looking to keep things simple, choose a corporate year-end of December 31, the same as your personal tax year-end.

There can be some advantages, however, in choosing an off-calendar year-end. For example, with an off-calendar year end of July 31 or later, you would be able to defer paying taxes for up to 179 days. This means you could declare a bonus in the company fiscal (non-calendar) year, but not actually take the money into (taxable) personal income into the following (calendar) year.

Your professional corporation will file its own return and pay its own taxes. The corporation's tax returns are due six months after

your designated corporate year-end, but the final balance of any tax owing is due two to three months after your corporate year-end.² As you will now be an employee of the corporation, and no longer a self-employed individual, your personal taxes will be due by April 30—and not the deadline of June 15 granted to self-employed individuals and their spouses.

A mistake that's often made in the first year of incorporation is failing to file for dividends, recorded on T5 slips, by February 28 of the following year. This oversight will result in a late fee of the greater of \$100 or \$10 per day.³ February 28 (or 29 in a leap year) is also the date for filing T4 slips. You will need to keep your company records for at least seven years—including invoices, receipts, cheques, and documentation of your salaried employees' duties and hours worked.⁴

When Does It Not Make Sense to Incorporate?

Although there are powerful potential benefits to incorporating your professional practice, there are also some (limited) situations in which it is advisable not to incorporate.

If you are retired and have no intentions of ever working again, ever, then incorporating won't be the right choice. To be crystal clear: I don't mean if you are retiring in one year, or slowing down or moving to part-time work. That's because there could still be many thousands in tax savings in those final years that could significantly change your corporate/RRSP mix, estate plans—and reduce your future tax bill, once you really are retired, as well.

In 2014, I started working with a physician in his 70s. Although he was in the process of reducing his working hours, we still had him incorporate his medical practice. By taking this one action, over the five remaining years of his working life, he achieved the following results:

1. His RRSP balance was reduced by \$200,000, reducing the income he would take in the form of RRIF withdrawals (and thus the taxes he would eventually pay);

2. His corporate investment account balance was \$250,000—giving him more control and lower (eventual) taxes;
3. The expected taxes payable on his estate were reduced, increasing his children's inheritance; and
4. He received five years of government benefit payments totalling close to \$40,000—none of which he would have received had he not followed our advice.

If you plan on working less than a year in Canada and then move permanently to a new country, then you should not incorporate.

Notice I didn't say "if you plan to move to another province," as your corporation can be portable. That is, the benefits of incorporation all hold true if you work in Ontario for, say, one year and then work in Alberta for the following 20 years. While oftentimes a share restructuring may be required (given the different rules in different jurisdictions), unless you are planning on working in both provinces, in most cases it is a better option to have one corporation that moves from Province A to Province B than to set up a brand-new corporation. This is called "continuing" the corporation—a corporation is said to have continued when it has moved from one jurisdiction to another. Keep in mind, however, that different regulatory bodies may have different requirements.

If you make less than \$50,000 per year and you do not have a partner who earns an income, you should not incorporate. In situations where your partner does have a high income and you can incorporate, there are ways to make this beneficial for you as a collective unit.

If you are an American citizen working in Canada, you should not incorporate until you understand the pros and cons, including excessive filing requirements—as the United States and Eritrea are the only countries that tax based on citizenship, resulting in annual filings for the prorated share of the passive income earned. Before you make the decision of whether to incorporate, you will need to understand which investment strategies can be used, *but also cannot be used*, given your citizenship and tax position.

Additionally, in December 2017, the United States implemented a transition tax that could be punitive for U.S. citizens working in Canada. With that said, I have worked with families for whom incorporation was certainly worthwhile—as in many other things, the devil is in the details.

If you have student debt, should you still incorporate? While student debt cannot be transferred to a corporation (given the debt is not tied to a tangible asset), it's still *almost always worthwhile to incorporate*. Why pay 20–40% more in taxes (by remaining unincorporated) to save 4% in interest (even though national student loan interest gives you a tax credit)? However, if you're facing a substantial student loan balance, you could look into federal student loan forgiveness programs that forgive up to \$40,000 of debt in a five-year period if you work a minimum of 400 hours in an underserved or remote community.⁵

What If You Have No Small Business Deduction?

While many professionals do not receive the small business deduction (SBD) as they are associated with a partnership (i.e., most incorporated lawyers with a large firm), most of the benefits from incorporating still apply. (Note that the 2016 federal budget introduced a number of changes to corporate taxation when income is earned in a partnership or revenue is received from another company.)

Often I see physicians who are working in partnerships where they share the SBD have solutions put forward to fix this problem, but require a majority of their colleagues to be on board. In most cases it does make sense to enter into a cost-sharing arrangement or the advisable solution put forward by the legal team.

At first it seems costly with no SBD, as your corporate taxes go up from 12.2% to 26.5% (in Ontario; this varies per province). However, you do receive an enhanced credit on your dividends that can range from 8% to 12% less in personal taxes, making up for much of that loss in having no SBD.

How Does Purchasing a Home Fit into My Incorporation Timeline?

What if you are buying a home in six months to two years' time—does it still make sense to incorporate now? In a word, yes. Your home is a leveraged investment that grows tax-free, and, because of these characteristics that are unique to the principal residence, will likely be one of your best long-term investments . . . like a “super-TFSA,” if you like.

You normally need between 25% and 35% of the purchase price as a down payment—and the fastest way to save the down payment is usually to incorporate.

(As a side note, I also advise clients that it is okay to potentially overreach a little more than normal on their home purchase price, to avoid having to purchase an intermediary home, and then eventually sell that intermediate home in order to purchase a long-term or “forever” home within a few years. That’s because the transaction costs in real estate, such as real estate commissions paid on the sale, can be significant. When all the transaction costs are factored in, they might represent up to 10% of the purchase price—a cost that can be avoided if we could somehow speed up the process to get into that long-term home.)

Let’s take a look at an example.

Saving for a Down Payment: Incorporated and Non-Incorporated Options

This example assumes the following:

- John is a physician earning \$400,000 per year who wants to buy a condo in Toronto for \$1,000,000.
- We’ll assume the growth rate on the condo is 4% per year, but for the moment we’ll ignore all real estate transaction costs (i.e., land transfer taxes, legal and real estate commissions, and so on).

- At a \$400,000 income, John's *average* tax rate will be 44%, though his *marginal* rate will be 53.53%.
- Let's assume John needs \$100,000 of after-tax ("take-home") pay to meet his day-to-day living expenses.
- John wants to save \$250,000 as a 25% down payment on the condo.

With no corporation, based on these assumptions John could save \$124,000 in the first year, and it would take him a total of two years and almost three months to make up the 25% down payment on a property that may well appreciate during John's "waiting period" (meaning his \$250,000 no longer represents a 25% down payment).

If John incorporates, his average corporate tax rate would be 12.2%, and he could pay out \$129,000 in dividends to fund his \$100,000 lifestyle spending needs (at an average tax rate of 22%), allowing him to save \$223,000 in the first year.

In this scenario, he will have a \$250,000 down payment within a time frame of about 15 months—cutting an entire year off the time frame for saving the required down payment.

And not only does John save up the down payment more quickly, he also saves about \$40,000 on the condo purchase price, given our projection about real estate appreciation over the waiting period. How is John able to realize his down payment savings strategy so quickly and effectively? The key is his use of a shareholder loan from his corporation, which we discuss next.

Can I Purchase My Principal Residence through My Corporation?

The answer is a qualified yes: you *can* purchase your principal residence through your corporation, but you usually *shouldn't*.

Why not? Because you'd be giving up one of the largest benefits the tax code allows, the principal residence exemption. This benefit

allows all the gains in our homes to grow tax-free, but the benefit is eliminated if the home is owned by the corporation.

Let's look at the example of a family member of mine, who purchased their home in 1987 for \$750,000. Fast-forward to 2017 and this same house was sold for \$4,850,000 (a gain of \$4.1 million over 30 years)—as a tear-down, believe it or not! Because the house qualified as their principal residence (sheltered under section 40(2)(b) of the Income Tax Act), they didn't have to pay even a cent of tax on the \$4.1 million gain—compared to a tax bill of over \$1 million if the corporation had owned the house. In a nutshell, if it's your plan to hold (own) the home for many years, or unless you think the house will not appreciate in value, it's best to own your home personally.

However, there are certain situations where one may want to consider owning their principal residence through the corporation.

Let's consider a situation in which you have almost all your funds in the corporation, which would result in a very large personal tax bill to come up with that 25%-plus down payment. Let's also assume we are purchasing a property to own for less than five years, so the likelihood of significant capital appreciation is relatively low.

In this case, the benefit of purchasing the property through the corporation would be to come up with the payments through lightly taxed corporate dollars, as opposed to much more heavily taxed personal dollars. However, given that the house is still a personal-use property (a tax concept that refers to items you own primarily for the personal use or enjoyment of your family and yourself), you would need to either pay rent to the corporation for the equivalent market rent—which results in having to pull out money from the corporation—or take a taxable benefit for the market rent.

The former (paying rent) allows further deductions in the corporation for many of the costs—such as interest, utilities, and hydro—but would likely result in a higher personal tax bill. That's because you would likely need to withdraw double the amount needed for rent in order to pay the tax due on the withdrawn income. This option could also create problems under the new passive income rules (which came into effect for taxation years

beginning after 2018), as rental income (paid to your corporation) counts toward the \$50,000 threshold.

All in all, the only situations in which we've seen it make sense to have the corporation own your principal residence is when you take a taxable benefit for the imputed rent. (This is a complicated area of tax law, where professional advice is most definitely warranted!)

In making your decision about whether to own your principal residence personally or through your corporation, you will need to estimate and weigh all these costs—loss of the principal residence exemption, potentially higher loan costs when borrowing corporately as opposed to personally—against the potential benefits, which are the savings of after-(corporate)-tax dollars versus after-(personal)-tax dollars.

What about Shareholder Loans?

As a shareholder, you can take a loan from your corporation. Here's how that works: you can personally borrow money from the corporation and will not have to repay the loan until one year after year-end, giving you a repayment window of up to 729 days. Shareholder loans can be helpful in situations like the one we've just discussed, when you need to take on debt for personal reasons—whether that's financing your personal residence, cottage, or vehicle.

On your corporate books, the loan will appear as an asset to your company and a liability to you. In repaying the loan, you will need to pay the daily prescribed interest rate (currently 2%) or have a deemed interest benefit, but this will be less than the current prime rate (currently 2.45%).⁶ All things considered, I would much rather see you pay the prescribed interest rate to your corporation than a higher interest rate to the bank for your debt payments.

One more note about shareholder loans: it is very important to make sure you repay any loan you receive from the corporation. If

you fail to repay the loan, you will have to add the borrowed amount to your personal income tax return, and you will be charged interest by the Canada Revenue Agency (CRA) for taxes owed. Also, once you have repaid the loan, you should avoid additional shareholder loans, as the CRA could potentially penalize you for a series of loans.

Does a Professional Corporation Give Me Creditor Protection?

A professional corporation differs from a “normal” corporation in that it offers no creditor protection to its directors and shareholders, and no protection from personal liability in the case of professional negligence.

While there are certain ways to ensure creditor protection for your assets, I believe the issue of creditor protection may not be as relevant in the medical industry, given that most professionals have coverage through their association. (Professionals should check with their provincial or territorial regulatory body for details on their particular circumstances.) The professional corporation can provide limited personal liability covering non-professional liabilities (such as office space lease liabilities and bank loans that are not personally guaranteed).

With that said, you can look at forming a separate holding corporation or investing in creditor-protected assets, such as segregated funds, to help provide extra measures of credit protection. Both options, however, will result in extra accounting, legal, or management fees—which is why a cost-benefit analysis should be completed with your financial advisor before you take any action.

If you own rental properties, however, we recommend using holding corporations for creditor protection. Although you may have adequate coverage through your association for your professional activities, that won't cover your rental properties, and a disgruntled tenant could lead to a creditor issue.

How Could I “Supercharge” My Charitable Donation?

Once you have incorporated, it’s probably time to rethink how you donate to charity. Whether we’re talking about donations that are as small as \$25 to support a colleague’s charitable run or tithing 10% of your income to your church, it is important to know the basics on how to maximize the tax effectiveness of your donation.

If you donate personally, you receive a 15% federal **credit** (plus provincial credit; e.g., in Ontario 5%) on your first \$200, then a 29% federal credit (plus provincial credit, e.g., in Ontario 11%) after that, and finally a 33% super credit for people in the top tax bracket. Given that donations can be carried forward for five years, if your donated amount is under \$200, you might as well defer it to a future year and claim all the donations together so you can benefit from the larger credit. Between 2013 and 2017, if this was your first donation—called the first-time donor’s super credit—you would receive an additional credit of 25% on the first \$1,000 in donations. (The first-time donor’s super credit expired at the end of 2017.)

If you donate corporately, you receive a tax **deduction** from your donation. This tax deduction reduces your taxes on your active income.

Usually with professionals, tax deductions are worth more than tax credits. The exception would be if you happen to have a very low personal tax rate, with the result that you can take funds out of your corporation at a lower rate than the credit you are receiving from your donation credit. (Keep in mind, however, that we have to eventually make up every dollar we spend personally by pulling more money from the corporation.)

But beyond deductions versus credits, there are other ways to increase the tax efficiency of your donated dollars. What many Canadians don’t realize is that as of May 2006, donations to registered charities of publicly listed securities are exempt from capital gains taxation on gains triggered as a result of the gift, making it more tax-efficient for donors to give securities directly to charity, rather than to sell them and give the proceeds to the charity.⁷

Let's look at an example of how this works: I work with a client who tithes to his local church, giving 10% of his income (\$60,000 per year) to his church. To help him accomplish this goal, we set up a charitable account for him at no cost (note, many banks and financial institutions charge thousands for this setup/transaction).

When the time comes for his donation, I take the best-performing asset from the previous year and roll that over to the church. In the last transaction we did, it was an investment with a book value of \$20,000 and a market value of \$60,000. The church receives the same \$60,000 they were to receive anyway, and they can sell the asset right away or hold on to it. The client, in turn, receives a \$60,000 tax deduction, but this also saves him upwards of \$10,000 in corporate taxes. Plus, the client can now withdraw \$40,000 from his corporation tax-free through the capital dividend account (CDA). Since 0% of the gain is taxable, 100% of the gain is added to the CDA (see sections 83(2) and 38(a.1)(i) of the Income Tax Act).

Think about all the times you have donated, or will donate in the future, to see how much money is left on the table if you are not employing this specific strategy. You could even use those tax savings to donate to your second-favorite charity!

What Is the Lifetime Capital Gains Exemption (LCGE)?

The lifetime capital gains exemption (LCGE) is an exemption, valued at \$883,384 for 2020 and indexed to inflation every year, that can be used when corporate shares are sold.

For example, if you sell your corporation for \$883,384 as a share sale, not an asset sale, then you would have no taxable capital gain and pay no taxes.

Given every Canadian has access to the lifetime capital gains exemption, in many situations where the shares would sell for more than \$883,384 (or whatever the limit is for that year), you would want to add family members, such as your spouse and/or children, to multiply the capital gains exemption. For instance, if

you and your spouse each owned shares, for 2019 you would have, between the two of you, a total of \$1,766,768 in tax exemptions ($\$883,384 \times 2$). You are not required to use the full LCGE all at once, however. Again, this can be a complex area requiring professional guidance.

(On a side note, a common misbelief is that this exemption is in some way related to the capital gains from the growth on your investments. While these are both forms of capital gain, their tax treatment is very different!)

Keep in mind the CGE only applies to the selling of shares, and not the selling of assets. This can sometimes lead to a mismatch between the seller and a prospective buyer, as sometimes the buyer would prefer to buy the assets, but—given the CGE—the seller would often be better off selling the shares. For example, you can see this mismatch when a seller is purchasing equipment that has already been depreciated on the balance sheet by the previous owner. As a buyer, you may then be in a position in which you are buying equipment for a higher value than you can depreciate, given the seller has already received the tax benefits from the years of depreciation. Depending on your side of this transaction, you may want to leverage this mismatch to influence the selling price.

Most physicians will not be able to benefit from this exemption, as it requires you to find a buyer for your medical practice. (A practice sale is much more common with dentists.) However, in recent years we have seen a rise in the sale of medical practices, given the value of patient rostering or family health organization (FHO) practices (using the FHO compensation model).

In order to qualify for the CGE, the corporation must qualify as a small business corporation at the time of sale. In order to qualify, two criteria must be met, the first being that you, or a person related to you, must have owned the shares for a 24-month holding period immediately prior to the sale. Secondly, 90% of the assets at the time of sale, and more than 50% of the fair market value of the assets held during the 24-month holding period, must have been used for

carrying on an active business in Canada, or be shares and debt held in other small business corporations (or a combination of these two types of assets).

For corporations that will not pass this test, there is a “purification” method to allow the shares to qualify. In order to purify your shares and thus qualify for the CGE, you will need to set up a holding company to transfer assets to. It’s very important to do this correctly. For instance, if you transfer funds as intercorporate debt, as opposed to an intercorporate dividend, your shares may be ineligible for the exemption. It should be also noted that while most assets can be transferred in kind, some assets—such as permanent insurance—may give rise to a taxable benefit if the cash surrender value (CSV) of the policy exceeds its adjusted cost base (ACB), though the ACB is usually negligible or nil in the earlier years of the policy. This is why it’s best to plan this sale carefully, to avoid paying unnecessary tax.

Before we leave this topic, note that the lifetime CGE has evolved since its creation in 1986. It started with a \$500,000 lifetime exemption on any type of capital gain, such as a cottage sale. In this early form, many Canadians could reap the rewards of the CGE. Then, in 1994, the CGE was reduced to \$100,000 and subsequently restricted to the sale of qualified small business property, including farm and fishing property. As a result, many Canadians “crystallized” (or claimed) \$100,000 of exempt capital gains.

This history is important as it demonstrates that tax policies can and do change. While many incorporated professionals will plan to use their CGE in retirement, in many scenarios it may make sense to use the lifetime CGE now, anticipating a potential rule change in the future. To use the exemption before retirement, you would trigger capital gains, resulting in an increase to the cost base of the shares. Then, when the shares are sold in the future the amount of tax paid would be dramatically reduced, due to the adjusted (increased) cost base.

Now That I Have Incorporated, Can I Deduct My Golf Membership Fees?

In a word, no!

Dues for recreational or dining clubs, such as golf or tennis clubs, are not deductible expenses, *even if* the expense has a business purpose, as there is a specific rule in section 18(1)(l) of the Income Tax Act that prohibits the deduction of all recreational club dues. For meals and beverages consumed at golf clubs and the like, however, the deductibility rules are the same as those that would apply at other restaurants, so long as the costs are separately itemized (they are generally 50% deductible, with some exceptions). If the full charge is shown and not itemized, the full deduction is generally disallowed.

As an aside, there was a Tax Court of Canada case involving Gillis Truckways Inc. (*Gillis v. The Queen*—2005 TCC 782) in which a golf membership was paid for by a corporation. In that case, the CRA reassessed a taxable benefit of 100% of the cost of the membership to Mr. Gillis, who brought the case to court; the judge directed the CRA to lower the taxable benefit down to 40% of the membership cost. Maybe with a golf lobby group the current tax rules could change!

What Do I Do with My Corporation When I Retire?

Assuming you do not sell your practice shares, when you retire your professional corporation needs to remove the “professional” title, leaving you with a numbered holding company. This is usually done with the help of a lawyer and your accountant, but this change doesn’t require you to sell any assets nor does it trigger any taxes. In addition, this change also allows you to modify the structure of shares however you wish. When looking at estate planning purposes, for example, you may want to freeze the value of your shares and issue new growth shares to other family members, or to a trust, to transfer future growth and taxes to that member.

Real-Life Case Example of Restructuring Shares

In 2015, I sat down with a client in his late 60s who had a significant amount of assets in his corporation, which we'll call "123456 Ontario Limited."

The client ultimately wanted to pass on his assets to his daughters in a tax-efficient manner. We collectively decided any life insurance solution was off the table—and starting in 2016, new top tax rates were coming into effect, with new surtaxes.

Here are my notes for the transaction we implemented:

Redemption of Preferred Shares Prior to December 31, 2015

Background: At present, retaining eligible dividend income within an Ontario corporation defers 0.49% in personal tax (the difference between the Part IV tax rate of 33.33% and the top personal marginal tax rate on eligible dividends of 33.82%). Assuming the Liberal party platform tax rate proposals are implemented, the top personal tax rate on eligible dividends will jump to 39.34%.

- 123456 Ontario Limited has a general rate income pool (GRIP) balance of \$1,295,018 (calculated as of April 30, 2015), which would allow for the payment of an eligible dividend of the same amount.
- The payment of a \$1.3 million dividend would result in personal tax of approximately \$439,660, but generate a refund of tax to the corporation of \$433,333 (an incremental tax cost of \$6,327).

Recommendation: As an alternative to paying a dividend, 123456 Ontario Limited could redeem a portion of the preferred shares issued to you.

- Assuming the preferred shares have a paid-up capital (PUC) (to be confirmed by your accounting firm), a redemption of \$1.3 million worth of shares would generate a taxable dividend of approximately \$1.3 million to you (the taxable dividend is the difference between the redemption amount and the PUC of the shares).

- The dividend can be designated by the corporation as an eligible dividend to the extent of the corporation's GRIP balance at the time of the share redemption.
- The advantage is that for a current net tax cost of \$6,327, the future tax exposure of your estate will be reduced by a minimum of \$347,880 (based on the anticipated 2016 top tax rate on capital gains of 26.76%), but more likely by as much as \$519,220, assuming the preferred shares will be redeemed on your passing (and based on an anticipated 2016 top tax rate of 39.34% on eligible dividends).

While this transaction took several steps, one can see that with the easing of restrictions on corporations in retirement, there are a lot more potential opportunities for planning!

Key Takeaways from This Chapter

- In many cases, professionals and business owners who are able to incorporate should do so—and the process may cost less than you think. So if you're able to incorporate but have not yet done so, ask your professional advisors why not?
- The main benefits of incorporation include the increased flexibility and control you gain, which can allow you to reduce your tax bill each and every year you're incorporated.
- Despite the benefits of incorporation, there are situations in which incorporating your business or establishing a professional corporation doesn't make sense. If one or more of those situations applies to you, consider holding off until the time is right.
- Finally, keep in mind that the corporation isn't a "magic solution" to create tax benefits out of thin air: you'll still need to play by the tax rules within the structure of your corporation.

Top Questions to Ask Your Financial Planner

1. If you're not incorporated and believe you're able to incorporate and the time is right, ask your professional advisors why not?
2. If the time isn't right for you to incorporate now, ask your advisors when they think the time might be right for you, and for a plan to get you there.
3. If you are incorporated, ask your advisors to walk you through how the corporate structure is being used to its full advantage for you, using this chapter as a guide.
4. If you are incorporated, do you have a plan for what happens with the corporation once you transition into retirement?

Notes

1. More information on the steps that follow incorporation can be found on the Government of Canada's Corporations Canada website at <https://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/cs06646.html>. Corporations Canada is Canada's federal corporate regulator.
2. Under section 248(1) of the Income Tax Act, the three-month limit is only available to CCPCs that (a) claimed the small business deduction in the current or previous year, and (b) did not exceed the small business limit on an associated group basis.
3. For more information, refer to the Canada Revenue Agency's web page on late filing of information returns at https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/payroll/penalties-interest-other-consequences/payroll-penalties-interest.html#late_filing_info_return.
4. For more information on your record-keeping responsibilities, refer to the Canada Revenue Agency's website at <https://www.canada.ca/en/>

revenue-agency/services/tax/businesses/topics/keeping-records.html.

5. For more information on student loan forgiveness for family doctors, refer to this Government of Canada web page: <https://www.canada.ca/en/services/benefits/education/student-aid/grants-loans/repay/assistance/doctors-nurses.html>.
6. Information on the prescribed rate can be found on the Government of Canada website, at <https://www.canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html>. The prime rate is usually the interest rate at which banks lend to customers with good credit. It's the annual interest rate that Canada's major banks and financial institutions use to set interest rates for variable loans and lines of credit, including variable-rate mortgages.
7. For more information, refer to the Government of Canada website, <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/line-34900-donations-gifts/capital-gains-realized-on-gifts-certain-capital-property.html>.