

# Incorporate or Not?

Is incorporating your business right for you?

As a sole proprietor, you may be wondering whether to incorporate your business. While incorporating is good for some, not all businesses will necessarily benefit from a corporate structure. If you are considering incorporating your business, you should take the time to learn about the possible advantages and drawbacks of incorporation. This article highlights some points you may want to review when determining whether to incorporate your business.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of a CCPC can be listed on a designated stock exchange.

## What is incorporation?

The act of incorporating creates a new legal entity. Your corporation will have certain rights and obligations, including the ability to acquire assets, obtain a loan, enter into contracts, incur legal liability and carry on a business. Once you incorporate, the corporation's assets belong to the corporation and not to its shareholders.

## Advantages of incorporation

There are several potential advantages to incorporating your business. The following is a non-exhaustive list of these advantages:

## Tax deferral

Perhaps the most significant advantage of operating your business within a corporation is the ability to defer taxes. Business income earned within a corporation is taxed at two levels – once at the corporate level and then again at the personal level when the income is distributed. By incorporating and earning business income within your corporation, you can defer personal taxation on the after-tax business income until the time you withdraw it from your corporation. Generally, the longer you can leave the funds in



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your corporation, the greater the deferral advantage will be.

This tax deferral is available because income earned from operating your business within a corporation may be taxed at lower corporate tax rates than business income earned while operating as a sole proprietor, where the income is taxed at your individual marginal tax rate. If business income is earned by your corporation, the taxable income may be considered active business income (ABI) for tax purposes and be subject to a general federal corporate tax rate of 15% plus the applicable provincial or territorial corporate tax rate. Further, if your corporation is a CCPC throughout the tax year, your corporation may benefit from the small business deduction (SBD), which lowers the federal tax rate to 10% for 2018 and 9% for 2019 on its first \$500,000 of ABI (known as the “business limit”).

As a result of these lower corporate tax rates for ABI, if you incorporated your business, you may have more after-tax business income to invest inside your corporation. Due to the larger amount of starting capital, you may realize after-tax returns that exceed what you may have realized in a personal investment account. In an attempt to limit this tax deferral benefit for corporations, the federal government introduced rules to restrict access to the SBD for CCPCs that have significant income from passive investments.

For taxation years that begin after 2018, a CCPC will have its federal small business limit reduced on a straight-line basis where the CCPC and its associated corporations earn between \$50,000 and \$150,000 of passive investment income in a year. The business limit will be reduced by \$5 for every \$1 of passive investment

income above the \$50,000 threshold. The business limit will be eliminated if a CCPC and its associated corporations earn at least \$150,000 of passive investment income in a year. As such, you may want to ensure that the passive investment income earned in your corporation does not grind down your small business limit.

All provinces and territories also provide an SBD and have a small business limit of \$500,000, except for Saskatchewan, which has a limit of \$600,000, and Manitoba, which has a limit of \$450,000 for 2018. Effective January 1, 2019, Manitoba has increased its small business limit to \$500,000. Additional criteria must be met in order to qualify for the Quebec SBD. Corporations will only qualify for the Quebec SBD if they operate in the primary or manufacturing sectors or where the corporation's employees worked at least 5,500 hours during the tax year. The provincial or territorial small business limit may also be reduced for CCPCs that have significant income from passive investments. Please confirm the specific rules of your province or territory of residence with a qualified tax professional.

In addition to the reduction described above, the business limit is reduced on a straight-line basis for a CCPC and its associated corporations where the group has between \$10 million and \$15 million of total taxable capital employed in Canada. The actual reduction of a corporation's business limit is the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income. Finally, the business limit must be allocated among all associated corporations.

### Income splitting opportunities

Incorporating your business may allow you to take advantage of income splitting opportunities. By having lower income adult family members as shareholders, the incorporated business can pay them dividends to take advantage of their lower marginal tax rates. That being said, it is important to note that there are “tax on split income” (TOSI) rules which limit splitting certain types of income with family members.

These TOSI rules apply to many types of income received from a private corporation, including interest, dividends, as well as certain capital gains, but they do not apply to salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income loses the ability to claim personal tax credits on the split income, such as the basic personal tax credit.

There are some exclusions to TOSI which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults age 18 to 24, and adults age 25 and over. There is also an exclusion available to the spouse of a business owner who is age 65 or older. The exclusions mainly rely on whether the family member is significantly involved in the business or owns a certain portion of the votes and value of the corporation's shares. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask an RBC advisor for our article discussing income splitting through private corporations.

<sup>1</sup> The term ‘associated corporations’ is defined in the Income Tax Act. The definition is complex and is beyond the scope of this article.

The process of making family members shareholders of your corporation is complex and may result in immediate tax consequences. Speak to a qualified tax and legal advisor for more information regarding a reorganization of your company.

You can also split income with family members using other methods that do not require you to incorporate your business or add them as shareholders of your corporation. For example, you can have your corporation pay reasonable salaries to your family members for the services they provide. This strategy allows you to take advantage of your family members' lower marginal tax rates while generating RRSP contribution room for them at the same time. Your corporation can claim a deduction for the reasonable salaries paid.

#### The lifetime capital gains exemption (LCGE)

You may enjoy a significant tax break on the capital gains you realize on the disposition of certain private company shares. Each individual resident in Canada can claim an LCGE to shelter capital gains on the disposition of qualified small business corporation (QSBC) shares. The LCGE was increased in 2014 to \$800,000 for dispositions of QSBC shares and is indexed for years after 2014 (you can find the current year LCGE on the Canada Revenue Agency's (CRA) website). Therefore, incorporating your business may enable you to sell your business and shelter the growth from tax, up to the LCGE limit.

You and your family may be able to multiply the LCGE available on the disposition of QSBC shares if you and your family members own shares of your corporation, directly or indirectly. For example, instead of only being able to claim one LCGE, assuming the LCGE is

\$800,000, a family of four can shelter up to \$3.2 million of capital gains, resulting in significant tax savings. Please note that if you multiply the LCGE with your family members, they become entitled to some of the proceeds of sale. It is important that this is your intention when contemplating such planning.

For more information regarding the types of shares that qualify as QSBC shares, please ask an RBC advisor for our article on the capital gains exemption on private shares. Also speak to a qualified tax advisor if you are a sole proprietor and planning to sell your business since you may be able to claim the LCGE by transferring all or substantially all of your business assets into a corporation and immediately selling the shares of the newly formed corporation.

#### Flexibility in remuneration

By incorporating your business, you gain access to use a combination of different forms of remuneration, including salary, dividends, and bonuses. The ability to choose the type and amount of remuneration may allow you to maximize tax deferral while still taking advantage of benefits such as creating Registered Retirement Savings Plan (RRSP) contribution room and participating in the Canada Pension Plan or the Quebec Pension Plan.

#### Flexibility in employee benefits

By incorporating your business, you gain access to certain types of employee benefits or retirement savings plans, such as an Individual Pension Plan (IPP) and a Retirement Compensation Arrangement (RCA), that would otherwise not be available if you were a sole proprietor or a partner in a partnership.

#### Implementing an IPP

An IPP is a defined benefit pension plan that a corporation can establish for its

owner or key employees. An IPP may be ideally suited for individuals over the age of 40 who earn a substantial amount of employment income. It is usually established for one individual member, say yourself as the business owner, but the benefits can be extended to your spouse and other family members if they are also employed by your corporation. In certain situations, an IPP can provide greater annual contribution room than an RRSP.

Contributions to an IPP provide an immediate tax deduction to your company and are exempt from payroll and healthcare taxes. You will not pay personal tax on the contributions until you receive the benefit in a future year (potentially when you are in a lower tax bracket). In addition, you may be able to split your IPP retirement benefits with your spouse, which may further lower your family's overall tax bill.

Lastly, in the event that you or your business runs into financial trouble, the assets in the IPP are generally protected from creditors. This may allow you to set aside significant amounts of tax-deferred income for your retirement while having the assets protected from corporate creditors. Speak with a qualified legal advisor before implementing any creditor protection strategies.

#### Implementing an RCA

An RCA can provide you with supplemental pension benefits so that you may maintain your standard of living in retirement. Typically, an RCA is part of a retirement plan, which may also include a Registered Pension Plan (RPP) such as an IPP set up by the company. An RCA may also provide pension benefits where a company does not have an RPP.

Contributions to an RCA provide an immediate tax deduction to your company and there is no upper limit on

the amounts that you or your company can contribute to the plan, provided the amounts are “reasonable”. Please keep in mind that the contributions to the RCA (and any income or realized capital gains in the RCA) are subject to a 50% refundable tax. This means that the amount of funds available for investment may be significantly less in the RCA than if the funds are left in the corporation to invest or in an IPP.

You will not be taxed on the RCA contributions until you receive the benefit in a future year (potentially when you are in a lower tax bracket). In addition, you may be able to split your RCA income with your spouse in retirement, subject to a limit.

Lastly, like IPPs, RCAs may provide a level of protection from your business’s creditors. Speak with a qualified legal advisor before implementing any creditor protection strategies.

#### Limited liability

Incorporation limits the liability of a corporation’s shareholders. This means that, generally, the shareholders of a corporation are not responsible for the corporation’s liabilities unless they have provided a personal guarantee. However, if a shareholder is also a director, that person could be liable for certain corporate liabilities (which may include unpaid wages and payroll taxes) in their capacity as a director.

#### Better access to capital

Raising money is often easier for corporations than it is for other forms of businesses. For example, your corporation would have the option of issuing bonds or share certificates to investors. As a sole proprietor or partner in a partnership, you might have to rely on your own money and your own ability

to obtain loans for capital. This can limit the ability to expand your business.

#### Continuous existence

If you operated your business as a sole proprietor or a partnership, your business would cease to exist upon your death. On the other hand, if you incorporated, your corporation would continue to exist even if every shareholder and director were to pass away. Your corporation would not have to be wound up and ownership of the corporation could transfer to your heirs. This greater permanency may allow you to plan for your corporation over a longer term.

#### Disadvantages of incorporation

While incorporating your business may provide certain advantages, you need to weigh these benefits against the potential disadvantages of incorporating, such as the initial and on-going accounting and legal costs of incorporation. Some of the drawbacks of incorporating your business are discussed below.

#### Increased complexity and cost

A corporation is a separate legal entity and has no physical form. As such, the corporation needs individuals (such as shareholders, directors and officers) to carry out the business activities on its behalf. This business structure is more complex. In addition, operating your business through a corporation may require you to adhere to a number of corporate formalities. For example, regardless of whether you are the sole owner or one of many owners of your incorporated business, the directors of the corporation will still need to pass a resolution to declare and pay dividends.

A corporation is also subject to greater regulation and compliance than a sole proprietorship or partnership. For instance, your corporation will have to

hold annual shareholder meetings and maintain corporate records. If there are any changes to the board of directors, your corporation will have to file notices with the government.

The administrative, legal and accounting costs associated with establishing and maintaining a corporation are also usually higher than those of a sole proprietorship or partnership. When setting up the corporation, your incorporated business must file certain documents with the government including articles of incorporation. If you ever make changes to the structure of your corporation, articles of amendment will need to be filed as well.

In terms ongoing professional fees, your corporation will incur more costs to file an annual corporate tax return and T5 slips for dividends paid.

#### Restricted use of business losses

Generally, in the first few years of operation, a business may generate losses due to high start-up costs and/or the cost of building a sales base. As a sole proprietor, you may use any business losses to offset your personal income from other sources. However, once you have incorporated, any business losses realized in the corporation must be applied against the corporation’s income and cannot be used to offset your personal income.

Whether you incur these losses as a sole proprietor or through your corporation, if you cannot use the losses in the year they are incurred, they are not completely lost. Business losses can generally be carried back three years and forward for 20 years to use against past or future income.

#### Restricted personal use of corporate funds

All the business income you earn as a sole proprietor is taxed in your hands

annually. As such, you can use the after-tax profits however you wish. On the other hand, if you incorporate your business, the after-tax profits belong to the corporation and you cannot use the corporate funds for personal expenses unless you first withdraw the money from the corporation. Depending on how you withdraw funds from the corporation (e.g., as salary, bonus or dividend), you will face different tax implications on the withdrawal.

#### Taxes at death

If you own shares of your corporation, you may be subject to double taxation on death. First, you are taxed on the capital gain arising from the deemed disposition of your shares at death. Then, if the corporation is wound-up or the corporation makes distributions to its shareholders in the future, a second level of tax is triggered. Alternatively, a redemption of the shares by your estate or your beneficiaries may result in a taxable dividend.

It is possible to defer this potential double tax by transferring the shares of your company to a surviving spouse or qualifying spousal trust on a tax-deferred basis. There are also other post-mortem planning alternatives that may eliminate this double taxation. For more information on strategies that may mitigate this double tax exposure, talk to your qualified tax advisor.

#### Employer health tax obligation

Corporations in several provinces have to pay a provincial health tax once the corporate payroll has exceeded a certain threshold. Speak to a qualified tax advisor regarding these obligations.

#### Should you incorporate?

After familiarizing yourself with some of the advantages and disadvantages of incorporating, here are some

questions you can consider when determining whether you should incorporate your business:

#### **Do you need a substantial portion of your business income to fund your annual living expenses and meet your financial goals?**

If so, incorporating your business may not make sense. You may not be able to benefit from the tax deferral advantage a corporation can offer if you need to receive a significant amount of the corporation's income as salary or dividends to support your living expenses. Keep in mind that using corporate assets to fund personal expenses can result in negative tax consequences unless you first withdraw the money from the corporation.

#### **Is your business profitable enough?**

If your business is in the early stages and currently generating business losses, you might consider delaying incorporation. As a sole proprietor, it might be beneficial for you to use the business losses against your personal income from other sources.

#### **Is your business expanding? Does it need more money to operate successfully?**

If so, incorporating your business may make sense for you since raising money is often easier for corporations than it is for a sole proprietorship or partnership.

#### **Is your business producing more income than it needs to operate?**

If so, incorporating your business may make sense for you. You may be able to take advantage of the lower corporate tax rates and the resulting tax deferral advantage by leaving the after-tax business income in the corporation until you need it. In this regard, you may want to ensure that the passive investment income earned in your corporation does

not grind down your small business limit. Alternatively, you may be able to benefit from income splitting opportunities such as paying your adult family members dividends to take advantage of their lower marginal tax rates, provided the TOSI rules do not apply.

#### **Do you need additional money to supplement your retirement?**

If so, incorporating your business may make sense for you. By incorporating, you have increased flexibility in choosing the type and amount of remuneration you can receive in retirement. For example, you can choose to leave the funds in your corporation for investing or have your corporation set up an IPP or RCA which can provide you with supplemental pension benefits, allowing you to maintain your standard of living in retirement.

#### **Do you need to consider the succession of your business?**

If so, incorporating your business may make sense for you. Your corporation will continue to exist after your death and will be able to pass to your heirs as you wish. Even if your heirs do not wish to continue on your business, they may still benefit from tax deferral by leaving the money in the corporation to invest. Alternatively, if you plan on selling your business, you might be able to use the LCGE to eliminate the tax on all or a portion of the gain on the sale.

#### **Conclusion**

Determining how to structure your business is an important decision that may have a significant impact on your business going forward. Speak with a qualified tax and legal advisor to ensure that you have taken into account all of your circumstances before deciding whether or not to incorporate.

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