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PCs are the smart choice for small tax-wary businesses

By VERN KRISHNA

The February federal budget brought welcome income tax savings for professionals. Doctors, lawyers and accountants with incorporated practices can now pay reduced federal taxes of 12 per cent on the first $225,000 (up from $200,000) on business income. The limits will increase by $25,000 a year to reach $300,000 by 2006. Coupled with the proposed increases in retirement savings plans limits to $18,000, professionals will have considerably greater flexibility in planning for their retirement. However, double-taxation of dividends when the company ultimately pays out its earnings to the professionals is a thorn in tax planning, and one must carefully consider its impact in setting up business structures.

Professionals must incorporate their practices in professional corporations (PCs) to obtain the tax savings. However, they cannot use a PC to limit their liability for negligence or malpractice. This makes the choice of form of business an important decision. Large law and accounting partnerships are better off practising as limited liability partnerships (LLPs) in order to limit personal liability of partners. On the other hand, sole proprietors and smaller partnerships of two to six associates will be better off practising through a PC and using insurance to protect against malpractice claims.

Professionals can also use a holding company 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 the holding company.

The difference between the tax payable by a PC and an unincorporated professional practice is significant. Individuals pay tax on their business income at progressive marginal rates, which vary between provinces. The top tax rate in 2003 is about 46 per cent in Ontario at approximately $105,000 of taxable income. In Alberta, the comparable rate is 39 per cent, in British Columbia 44 per cent and in Nova Scotia 47 per cent. In contrast, the corporate tax on a small business PC is about 20 per cent. The 26-percentage-point spread in taxes means that by 2006 professionals will be able to defer up to $78,000 of tax every year if they leave $300,000 of income in the corporation. In a small partnership of six persons, for example, each partner could defer tax on $50,000 of taxable income.

Reinvestment of the maximum $78,000 tax savings each year at 5 per cent (after tax) creates an annuity of $3,900. In 30 years, the investment income will accumulate to nearly $260,000 after corporate taxes. Coupled with the increased annual limit of $18,000 on contributions to retirement plans, professionals should be able to create a reasonable retirement pension.

Deferral is the key to effective tax planning with a PC. Without tax deferral, there is no advantage to a PC. Indeed, there can be disadvantages in the form of higher costs in maintaining and operating a corporation and double-tax penalties on excess income left in the corporation. The tax system will integrate corporate and personal taxes almost completely up to the $300,000. Over that amount, however, the system penalizes shareholders by double-taxing their income, first at the corporate level and then again in the shareholders' hands. The double taxation of dividends is a real problem that requires considerable care in tax planning.

Lawyers, doctors and accountants, particularly those in small practices, have a lot to gain from the new corporate tax regime. Although PCs do not protect professionals from malpractice, the incorporation of medical, legal and accounting practices allows professionals to set up surrogate pension plans to supplement their retirement savings.

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