

## **INCORPORATING YOUR BUSINESS**

### **Should you incorporate your business?**

The facts required to answer this question used to be quite straight forward and a yes or no answer easily determined. However this is no longer the case.

### **What has changed?**

British Columbia corporate tax rates on small active businesses have reduced very significantly over the last few years, from a high of approximately 26% to approximately 13% in 2010. Earning active income in a corporation is taxed at a very low rate.

Canada Revenue Agency has begun in recent years to scrutinize income splitting with family members and incorporation, done properly at the beginning and maintained properly, can significantly reduce the risk of income splitting with family members.

The significant increase in Canada Pension Plan rates, the development of Individual Pension Plans, the use of Deferred Profit Sharing Plans and even the changes in personal tax rates have all impacted the incorporation decision

The decision to incorporate must now be made with a full understanding of the specific situation. The decision must be based on maximizing family cash flow, both short term and long term and a full understanding of the "family" situation is required to make a correct decision.

If you have questions or would like a review of your current situation we would be pleased to meet, with no obligation on your part, and review your personal family situation.

The following information provides more detail on some of the issues.

### **Why Incorporate?**

There are a number of advantages to incorporating a business, rather than operating as a sole proprietor:

1. Increased opportunities for income splitting with family members - income earned by the corporation may be paid out to persons other than the proprietor by paying reasonable salary and/or dividends to family members.
2. Opportunities to save and defer tax - the corporation and individual are two separate taxpayers and are taxed at different rates.
3. Opportunities to shelter capital gains on the sale of shares of the corporation -when selling shares of a "qualified small business corporation" (QSBC), it may be possible to use the capital gains exemption so that up to \$750,000 of the sale proceeds per shareholder are not taxed. (There are very specific rules that must be followed)
4. Limited liability - As a corporation is a separate legal entity, in the absence of personal guarantees only the assets of the corporation can be used to pay its creditors. If an unincorporated business runs into difficulties, paying off its debts could consume all the assets of its owners.

## **Tax Savings and Tax Deferrals**

The main benefit of incorporation is the potential for both saving and deferring tax as a result of tax rate differentials.

Tax savings are experienced when dividends are paid to shareholders of the corporation who can then use the funds to pay for family lifestyle expenses. The amount of tax saved results from the spread between the lower and highest personal income tax rates. The use of a family trust to own the shares can provide a method whereby many family members can receive dividends and take advantage of lower personal tax rates.

If the shareholders do not require all of the income produced by the business to support their family's lifestyle, cash may be kept in the business, invested and the second level of tax (personal) deferred until ultimate distribution. The amount of tax deferred depends on the difference between the corporate tax rate on income up to the corporation's small business limit and the individual's personal tax rate.

The family can generate very significant increases in cash flow using the above strategies.

## **Initial Decisions Regarding Incorporation**

### 1. Share Structure

The selection of an appropriate share structure for the corporation can only be made after the individual's income and other objectives have been identified. The structure is dependent on the income splitting strategies to be used (spouse, children, family trust), anticipated future use of the capital gains exemption, creditor-proofing issues and optimizing the small business deduction.

A corporation may have many different classes of shares with each class having different voting rights, dividend entitlements, rank in the event of dissolution, redemption rights, etc.

### 2. Where to Incorporate

A business may be incorporated under the Canada Business Corporations Act, the BC Company Act, or one of the other provincial corporation acts. The costs and advantages of incorporating in the different jurisdictions will need to be discussed with your lawyer.

### 3. Corporate Name

Corporations are assigned a number that it can use as its name, or one can choose to use a proper name.

### 4. Timing of Incorporation

If a brand new business is being started, you should consider if the business should be undertaken by the corporation from the very beginning.

If the business has already been established (either as a sole proprietorship or as a partnership), as part of the incorporation process the assets of the business will need to be transferred to the corporation.

A sole proprietor who transfers his business to a corporation in mid-year will have a deemed year end upon the cessation of the business (at the transfer date) and will not be able to claim capital cost allowance in that year, as he will no longer own any assets. If the capital cost allowance claim is significant, consideration should be given to incorporating immediately after the end of the proprietor's normal fiscal period.

For individuals in partnerships who are transferring their business to a corporation, care must be taken to time the transfer so that no adverse consequences arise from a negative equity position at the transfer date.

## 5. Choice of Year End

A new corporation must pick a year-end within 53 weeks from the date of incorporation. There are many factors to consider when selecting a year-end date, including the ability to defer income (bonuses) to shareholders/employees, the business cycle of the corporation and minimizing administration costs.

## **Mechanics of Incorporation**

### 1. From a Sole Proprietorship

Sole proprietors should be able to transfer all of the assets of their proprietorship to the corporation on a tax-deferred basis. The corporation will receive the assets at their tax basis to the proprietor.

A legal agreement for the purchase and sale between the individual and the corporation will be required for the transfers. This agreement will detail the property to be sold and the combination of shares, assumed liabilities and debt taken back as consideration. In order to determine the fair market value of the business, it may be necessary to have a valuation of the business.

### 2. From a Partnership

A tax deferred transfer of assets from a partnership to a corporation is also possible, although more complicated both from a tax and legal perspective. The method of the transfer will depend on the desired ending business structure. The partnership may be transferred to one corporation owned by all of the former partners or each partner may form their own corporation and the corporations form a partnership. The rollover of partnership interests into individual corporations would allow each partner to have more flexibility. Every partner would not be required to incorporate under such a scenario.

### 3. Goods and Services Tax (GST) and Social Services Tax(PST)

Depending on whether or not the entire business is being transferred to the corporation, what type of assets are being transferred and whether or not the individual and the corporation are registered for GST purposes, GST may be payable on the transfer of assets to the corporation. In most instances, a joint election may be filed by the vendor and the purchaser so that no GST will be payable on the supply of the business assets.

Most new incorporations in BC can be structured so as to avoid any adverse PST

consequences.

## **Other Issues to Consider**

### 1. Small Business Deduction

The Small Business Deduction is available to Canadian-controlled private corporations on the first \$ 500,000 of "active business income.

The corporation will have to share the small business deduction with other corporations that it is associated with. Corporations may be associated if they have significant common ownership control. There are a number of complicated rules in the Income Tax Act that determine whether or not corporations are considered to be associated.

Each individual will need to review what other corporate shareholdings they and their family members own.

### 2. Goods and Services Tax (GST)

Just as for unincorporated businesses, the GST will need to be charged by most corporations on the goods or services provided. Businesses with less than \$30,000 of sales are not required to register (no tax is charged on sales and no input tax credits permitted for GST incurred).