

INCORPORATING YOUR BUSINESS

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 (this is illustrated further in the Tax Rates section of this memo).
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. While the definition of a QSBC is quite stringent, in general the shares of a corporation engaged in an active business should qualify as long as the corporation has not accumulated substantial non-active business / investment assets (each corporation must be reviewed in detail to determine this). If substantial non-active business assets have been accumulated there are methods available to "purify" the corporation so that it does qualify.
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 Rates

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 with little or no other income and who could 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. If a spouse or adult family member is a shareholder, directly or indirectly through a family trust, each such shareholder could receive approximately \$26,500 "non-eligible", or regular dividends or approximately \$50,000 in "eligible dividends" (a specific type of dividend) in 2010 free of personal tax if they had no other source of income. This creates a tax saving of at least \$5,500 per person, assuming the "proprietor's" taxable income is over \$72,000.

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 and the individual's personal tax rate.

The tax rates for 2010 in BC are as follows:

Top personal income tax rate - 43.70%

Corporate tax rate up to the first \$500,000
of active business income - 13.50%

Active business income in excess of
\$500,000 - 28.50%

Relationship Between the Individual and the Corporation

Once a business has been incorporated, the role of the individual changes. Instead of being self-employed, the individual is now an employee and also likely a shareholder and a director of the corporation.

Every corporation requires a Board of Directors. The shareholders of the corporation must appoint at least one director. The director does not have to be a shareholder. Directors may be personally liable for HST and payroll deductions collected by the company and not remitted to the Canada Revenue Agency

(CRA), for environmental damage caused by the company, etc. Directors are required to demonstrate that they have done their best to prevent the unpaid amounts from occurring; simple ignorance of the events is not a sufficient defense.

It is often advisable for the spouse who is the director to limit their ownership of family assets. We do not recommend both spouses being directors. You should discuss this with your legal advisor.

Anyone can be a shareholder of the corporation. All shares must be purchased at their fair market value in order to avoid adverse tax consequences. In the absence of personal guarantees, a shareholder's liability to the corporation's creditors is limited to their share capital.

Shares of the corporation may be purchased and held directly by family members or they may be owned indirectly through the use of a family trust. Please note that as a result of the tax on split income (also termed the "kiddie tax") a private corporation should generally not pay dividends on shares owned by minors as this income will be taxed at the highest tax rate.

The use of a family trust to own the shares provides several advantages. The use of a family trust should be discussed with your KNV advisor.

Initial Decisions Regarding Incorporation

1. Share Structure

The selection of an appropriate share structure for the corporation can be made only 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, asset protection issues, optimizing the small business deduction, which legislation (federal or provincial) the business was incorporated under, etc.

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 Business Corporations 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.

Once a business is incorporated, it is critical to ensure that all aspects of the business are conducted through, and in the name of, the corporation and not the individual. This is important to establish the separate existence of the corporation. A failure to adhere to the legal form and substance of the arrangement may lead to a finding that the corporation is carrying on the business as an agent for the individual. This may result in the business income earned by the corporation being taxed in the individual's hands. The customers of the business, and the general public, must be aware that the corporation, not the individual, is conducting the business.

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 (CCA) in that year, as he will no longer own any assets. If the CCA 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 of 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 the minimization of 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. If the appropriate income tax election form has been filed, the corporation will receive the assets at their tax basis to the proprietor. In return, the proprietor may receive a promissory note, or have the corporation assume the sole proprietorship's liabilities, equal to the tax basis of the assets transferred. Any liabilities in excess of this amount should either remain with the individual personally or be exchanged for a promissory note payable to the corporation by the individual. If the corporation assumes additional debt, the asset transfer will not take place on a tax-deferred basis.

If any work-in-process exists, even if it is usually deferred for tax purposes, it must be included as one of the assets transferred to the corporation (with a tax basis of \$nil). Another asset to be considered in the transfer is goodwill. Goodwill usually has a \$nil tax basis but, if the individual paid for the goodwill, it may have a higher transfer price which can be withdrawn tax-free from the corporation.

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 undertake a formal valuation of the business. To the extent that the assets transferred to the company have a value in excess of their tax basis, shares of the company are usually issued for that excess amount and a special tax election is filed.

2. From a Partnership

A tax deferred transfer of assets from a partnership to a corporation is also possible, although more complicated from both a tax and a 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.

The above comments regarding debt assumption, work-in-process and goodwill in the context of a sole proprietor also apply in the partnership situation. In the partnership scenario, there is also the potential for a negative partnership equity position. Generally, negative partnership positions should be eliminated prior to the transfers as, if they are not, the partner will realize a capital gain in the year of the transfer. Depending on the particular tax circumstances of the individual, however, this capital gain result may be desirable, either because of the current lower capital gains tax rates or because the partner has unused capital losses.

3. Harmonized Sales Tax (HST)

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 HST purposes, HST 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 HST will be payable on the supply of the business assets.

Other Issues to Consider

1. Small Business Deduction

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

The corporation will have to share the small business deduction with other associated corporations. Corporations may be associated if they have significant common ownership and 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 have.

2. Harmonized Sales Tax (HST)

Just as for unincorporated businesses, the HST will need to be charged by most corporations on the goods or services provided. Businesses with less than \$30,000 of annual sales are not required to

register (no tax is charged on sales and no input tax credits permitted for HST incurred).

If a corporation has sales of less than \$200,000, they may be eligible to elect to use the "Quick Method". A corporation that provides services would charge 12% HST but only remit to the CRA 7.2% on the first \$30,000 of sales and 8.2% on the remainder. The business would not be eligible for input tax credits except on capital asset purchases. This option is beneficial when corporations primarily have business expenses with little or no HST paid on them (e.g., salaries).

3. Extracting Funds from the Corporation

There are a number of possible ways to extract funds from the corporation:

- a) The promissory notes payable to the individual in exchange for the tax basis of the assets transferred in may be withdrawn from the corporation as a tax-free reduction of the note.
- b) The individual may be paid a salary from the corporation. In determining the salary to be paid consideration should be given to utilizing low personal tax brackets, creating RRSP contribution room, CPP contributions, the timing of payroll remittances vs. personal quarterly instalments and the small business deduction available to the corporation.
- c) Reasonable salaries may be paid to family members for work performed in the business (no different than when unincorporated).
- d) Income may be left and taxed in the corporation. Later, when the funds are required they may be withdrawn from the corporation as a taxable dividend to the shareholder. The combined corporate and personal tax will approximately equal the tax that would have been paid by the individual if the income had been earned directly. There is a benefit from the deferral of the second level of tax until the dividend is paid.

4. Payroll Remittances

As an employee, the individual will receive a salary that is subject to withholdings for income tax, Canada Pension Plan (CPP) contributions and possibly Employment Insurance (EI) contributions.

Payroll remittances will need to be made periodically by the corporation (the exact timing depends on the size and frequency of the payroll) and include the income taxes withheld on salaries paid and both the employer and employee portions of any CPP and EI amounts. Please note that there is no EI payable on salaries paid to shareholders owning more than 40% of the voting shares of a corporation and employees who are not engaged on an "arm's length" basis with the company.

5. Automobiles and Home Offices

If the individual is required to use an automobile in carrying out their duties as an employee of the corporation, generally, the corporation should not purchase the automobile. In most circumstances, it will be more beneficial for the employee to own their own car and receive an allowance from the corporation. A "reasonable" allowance (based solely on business kilometers driven and reimbursement of expenses such as parking) received by the employee, is deductible to the corporation and is not included in the employee's income. A calculation should be done to determine who should purchase the automobile.

To the extent that the employee's/shareholder's home is genuinely used in the business the corporation may be able to reimburse the employee/shareholder for a portion of their home expenses.

6. Employee Benefits

As a director, the individual will have to consider which benefits the corporation will make available to its employee(s).

Benefits provided by the corporation to its employees that are taxable to the employees are less expensive to the employee than if the employee incurred the expense themselves with after-tax dollars.

Amounts paid by the corporation for a group medical benefits plan (other than the provincial MSP plan) for employees are not considered to be a taxable benefit to the employees. Premiums for the employees' group short-term disability plan, if paid by the corporation, are also not considered a taxable benefit.

Long-term disability premiums are usually paid for by the employee so that any payments received under the plan are not taxable to them.

7. Income Tax Instalments

Both federal and provincial corporate instalments are payable monthly. No instalments are payable during the corporation's first fiscal year.

8. Cost of Incorporation and Reporting Requirements

There are legal and regulatory costs to incorporate the company. There are also annual costs associated with maintaining the corporate minute books, preparing the company's annual financial statements and preparing the corporate tax returns (both federal and provincial).

September 2, 2010

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INCORPORATION CHECKLIST

1. Are you an employee or self-employed? _____

2. Jurisdiction to incorporate:
– Federal or Provincial _____

3. Proposed Name of Corporation

- i _____
- ii _____
- iii _____

4. Share structure:

- Common shares
- Other shares and rights
 - i _____
 - ii _____

5. Proposed shareholders:

	<i>Name</i>	<i>Relationship</i>	<i>Age</i>
1.	_____	_____	_____
2.	_____	_____	_____
3.	_____	_____	_____

6. Fiscal year end: _____

7. Other issues: