THE LAWYER'S DAILY

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Tax

Tax treatments of professional corporations: How to change

By **David Rotfleisch**

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(October 11, 2017, 8:47 AM EDT) -- This is the last part of a three-article series reviewing the tax implications of different kinds of law firm structures.

Professional corporation (PC)

Professional corporations allow lawyers to enjoy the tax benefits of a small business corporation, although not the limited liability protection. The professional corporation is the most tax efficient structure available for a sole proprietorship or small partnership.

An incorporated law practice enjoys the benefit of the small business deduction. This means that for active business income of up to $500,000, there is a federal and provincial tax reduction. In 2017, the combined federal and Ontario tax rate on active business income is 15 per cent. Contrast this to the top personal marginal tax rate in Ontario of almost 54 per cent. Other provinces have similar discrepancies between active business earned in a corporation and personal tax rates.

The Canadian corporate and personal income tax systems are integrated, meaning that income earned in a corporation and paid out to the shareholder is taxed at the same rate as income earned directly by the individual.

So why is there this rate discrepancy? The key concept is that there are two stages of taxation when income is earned personally. The first stage is the corporate tax, 15 per cent in Ontario as we saw above.

What about the missing 39 per cent? It is paid when the corporation pays dividends to the shareholder. So long as the law firm profits are left in the corporation the remaining 39 points of tax are deferred. Furthermore, the profits left in the corporation can earn income, albeit at a high rate. The minister of Finance announced proposals in July 2017 to tax those deferred profits, but the form and nature of that taxation has not yet been specified.

The law firm professional corporation can also choose a non-calendar year-end. This effectively allows for a one-year deferral of all income. For example, if you have a January year-end, your profits for the year ending Jan. 31, 2018, (which consist primarily of 2017 earnings) can be paid as a dividend in 2018 and thereby brought into income in 2018.

Income splitting, through salaries to a spouse and children based on the fair market value of the services provided, can be carried out with a law firm proprietorship as well as with a professional corporation. However, the PC can also accomplish income splitting through the payment of dividends, another area of attack in the July 2017 proposed changes.

A little known but extremely important tax benefit is the ability of the professional corporation to set up a private pension plan for the lawyer owner. This allows greater contributions toward a retirement pension than can be accomplished through RRSP contributions.

Change of law firm structure

The benefits of a professional corporation in the right circumstances are manifest. So, what do you do if you're practising in a proprietorship or in a partnership and want to enjoy those tax benefits? Or if you want to transition from a proprietorship to a partnership or LLP rather than into a PC? A tax deferred reorganization is available for a proprietorship into a partnership or into a corporation, or for a partnership into a corporation.

Section 85 of the *Income Tax Act* allows an individual or a partnership to transfer their assets into a corporation. This is referred to as a rollover. All assets, including goodwill, should be valued. Those assets are then rolled into the corporation and the parties elect to have that transfer take place at their adjusted cost base, thereby deferring any capital gain that would otherwise take place. Thereafter, the former proprietorship or partnership will be operating in the professional corporation with all of the tax benefits discussed above available.

A similar rollover is available for a proprietor who wishes to move into a partnership structure.

For part one of the series, click here. For part two, click here.

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