

TAXTICS

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Incorporating Your Professional Practice

inside

Physicians, dentists and most other professionals are now allowed to operate their practices through a professional corporation.

The primary reason for operating through a corporation is that it offers the practitioner a significant tax deferral advantage which can be used to increase the practitioner's after-tax accumulation of wealth. The main drawback is that the corporate form does not provide the practitioner with any additional protection from professional liability or negligence claims.

A professional corporation will only pay tax of 19% on its first \$300,000 of income, whereas a professional practising personally will pay tax at the highest personal tax rate of 46% on income in excess of \$115,000. If after-tax income is retained by the professional corporation (resulting in a difference in tax rates of 27%) and invested for a sufficient period of time the practitioner will increase his after-tax wealth, even after having to pay tax on the dividends as funds are withdrawn from the company in the future.

The Government of Ontario has proposed to extend an additional benefit to physicians and dentists effective January 1, 2006. It is proposed that family members of the

professional be allowed to become non-voting shareholders of the professional corporation. There is the potential for significant income splitting opportunities if this legislation is passed.

As an example, let us look at a married professional who earns \$250,000 and whose spouse is not employed. If the professional were operating personally the family would retain \$150,000 after taxes. However, if the practice were incorporated and the professional and the spouse were 50-50



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The Payment of Director's Fees to Children – A Precautionary Reminder

It is often said that bad facts make bad law and this is clearly evident in a recently released Tax Court of Canada case (Manchester Chivers & Associates Insurance Brokers Inc. - 2005 TC 402). The case involved the payment of directors' fees by an insurance broker to four adult children of the shareholders. Mr. and Mrs. Manchester and Mr. Chivers were the only shareholders of the company. The directors of the company were these three individuals, three adult children of Mr. and Mrs. Manchester and one adult child of Mr. Chivers. The Canada Revenue Agency ("CRA") disallowed all of the directors' fees paid to the four adult children for the three taxation years in question.

None of the children were employed by Manchester Chivers other than in their capacity as directors of the company. For the most part, the children did not live at home during the period under consideration. One of the children was employed in the insurance industry by a different firm in a different city. The court agreed that child is currently a realistic candidate to take over the affairs of the corporation. Mr. Manchester admitted in his testimony that the children did little as directors of the company other than sign the necessary corporate documents as required of directors. The children were made aware of the liabilities, particularly the statutory liabilities, to which they were exposed as directors of the company.

Two arguments were put forth by the CRA in support of the disallowance of the directors' fees. The first was that the directors' fees were not incurred for the purpose of earning income. The court quickly dismissed this argument. The second position was that the fees were not reasonable in amount. The court agreed with this argument and, in the end, disallowed all but a small portion of the directors' fees actually paid (the decision of the court was to allow a deduction of \$ 11,800 in respect of one child (for only two of the three years) and \$ 1,500 in respect of each of the other children for any year in which compensation was paid).

These cases are all factually driven and, in this case, the facts were almost as bad as they can get. The children performed minimal duties, they attended no directors' meetings, they had no experience and no apparent interest in the business and there was no evidence that they could make a worthwhile contribution to the board. There was nothing in their remuneration on a current basis that could properly relate in a reasonable way to some future goal of succession. Lastly, they received widely differing amounts of annual compensation as directors despite the fact that they all made approximately the same minimal contribution to the business. At the end of the day, it is perhaps not surprising that the Court concluded as it did.

This is not the only case dealing with the deductibility of payments to family members. In some cases, the outcome from the taxpayer's perspective is more favourable. However,

there are some lessons to be learned from all of these cases and it certainly doesn't hurt to be reminded from time to time of the risks involved. When it comes to compensating children of shareholders, particularly when the children are compensated as directors, the lessons to be learned from this case include the following:

1. Don't assume that the CRA will ignore any compensation below any specific dollar amount. In this case, the children were paid varying amounts ranging from a low of \$ 1,500 to a high of \$ 40,000 and the CRA disallowed all such payments.
2. Some differential in compensation is reasonable as among directors where any reasonable distinction can be drawn.
3. Barring a business explanation (such as a deficiency in a prior years' compensation, years of service, a regulatory requirement, etc.) it is not reasonable that a corporation expense more for fees in respect of one director than for another where the other made, objectively and subjectively, the same or a greater contribution.
4. If the children are to be compensated as directors, hold periodic directors' meetings, document the meetings and otherwise involve the children in the board's business to the greatest extent possible.

One last comment is worth noting. The denial of the expense in this case amounted to double taxation because the expenses were disallowed to the company notwithstanding the fact that the children included the fees in income (and were not reassessed to remove this income). This is not the normal consequence in cases of this nature. The Tax Court had some advice in this regard. It offered the following suggestions:

"In cases like this it is possible to consider that the parents were the constructive recipients of the fees paid. If such an approach had been taken, the deduction might have been allowed as bonuses paid to the parents whose services would typically warrant the expense. Such an approach would frustrate the tax planning aspect of this case but avoid the double tax. This is not to suggest one way or the other as to which approach the [CRA] should take in cases such as this. It simply recognizes an approach often taken by the [CRA]."

In the past, the CRA has often been willing to resolve cases on this basis. Hopefully, they will continue to do so in the future but only time will tell.

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Utilizing Health & Welfare Trusts

A health and welfare trust is an arrangement that allows employers to fund a trust for the provision of certain health and welfare benefits (such as health coverage) for employees on a tax-deductible basis.

A payment by the health and welfare trust to cover medical expenses or provide insurance coverage does not give rise to a taxable benefit for the employee. An employee can be given the flexibility to choose how to spend their allocation provided the expenditure meets the definition of a medical expense which is deductible under the Income Tax Act.

To help understand when such an arrangement is beneficial, one only needs to look at the accompanying chart, which compares the cost of using a health and welfare trust funded by the employer to pay out \$50,000 of medical expenses for an employee as opposed to having the employee pay for them directly.

<u>No HWT</u>	
Taxable income to Individual	\$100,000
Taxes (approx.)	(46,000)
Less medical Tax Credit	10,500
Net Income	64,500
Medical Expenses	(50,000)
After Tax and Medical	14,500

<u>With HWT</u>	
Corporate Income	\$100,000
HWT contributions	50,000
Administration fee (10%)	(5,000)
Taxable Income to Individual	45,000
Taxes (46%)	(21,000)
After tax and medical	24,000

Savings \$9,500

By using the health and welfare trust there is a net savings of \$9,500 since the medical expenses are funded by the corporation and the individual employee does not need to extract monies from the corporation on a taxable basis in order to fund the medical expenses.

The administrator of these plans are compensated by way of a maintenance fee based on the amount of monies that are flown through the health and welfare trust. Some providers also charge a set up fee for the establishment of a health and welfare trust. It is best to speak to a few providers and/or ask for a referral from one of your own financial advisors before proceeding.

If the benefits of the health and welfare trust will only be offered to persons who are shareholders of the company, care should be taken to ensure that the contributions will remain tax deductible to the company and to ensure that

shareholder benefits are not assessable.

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IPP's – Super size Your Contribution!

If you are over 40, have worked for a company for several years, and have employment income over \$100,000, an Individual Pension Plan (IPP) may be the next step in planning for your retirement. An IPP is essentially an upgrade to your RRSP, where an incorporated employer makes contributions based on actuarial studies that ensure there is sufficient funding for a pre-determined pension benefit. The main benefits to the employee are that he or she can contribute more towards an IPP than to an RRSP, the future benefit is defined, and assets held in the IPP are creditor proofed. If the employee has been employed for several years, he or she can catch-up for past service contributions back to 1990.

In addition, the company can make contributions up to 120 days after the year-end. Any administration fees incurred are deductible by the corporation (vs. no deductions for RRSP's) and there is no pre-set deduction limit.

To illustrate the benefits of an IPP, take a hypothetical situation where an individual, who is 50 years old, has been an employee with a certain company since 1991 and has a salary of \$100,000. Using the statutory yearly rate of return of 7.5%, maxing out his or her IPP contribution room and RRSP will accumulate approximately \$1,729,829 in registered retirement assets by the age of 65, as compared to \$1,143,622 through RRSP contributions only. Upon implementation of the plan, the corporation can make catch-up contributions up to \$96,187 on behalf of the employee for past service back to 1991. In year 1, the annual contributions to an IPP may exceed RRSP contributions by \$5,867 (\$22,367 to an IPP vs. \$16,500 to an RRSP). By year 14, the annual contribution to an IPP would exceed an RRSP contribution by approximately \$23,647 (\$57,869 vs. \$34,222). The total additional contributions would amount to \$282,861 and would accumulate to \$586,207 at the yearly rate of return of 7.5%.

An IPP may be worth considering if a large bonus is going to be paid out to an employee. If the employee does not require all of the bonus amount for personal living costs, it may be possible to shelter a large portion of the bonus by way of a catch-up past service contribution. However, it should be noted that once the IPP is registered, the pension is locked in, contributions are mandatory, RRSP contributions are restricted, there are no spousal contributions, and costs are typically higher to administer the plan.

Incorporating Your Professional Practice cont'd

shareholders, the family would retain \$172,000 after taxes. By earning fees through the corporation rather than personally, the family's annual cash flow would increase by \$22,000.

Similar benefits could be achieved with children that are at least 18 years of age. For example, a professional may intend on funding their child's post-secondary education. If the adult child is a shareholder of the company, they can receive as much as \$32,000 of dividends per annum on a tax-free basis assuming they have no other income. Whereas if the professional withdrew a \$32,000 dividend from the corporation to fund the costs of the education, he or she would have to pay \$10,000 of personal tax on the dividend.

There is no indication at this time that the income splitting benefits will be extended to all incorporated professionals, although one would expect that the various professional bodies will lobby for equal treatment.

Having family members as shareholders of the corporation may have an impact on how the professionals' family protects their assets. For example, will the new legislation extend liability for professional negligence to all shareholders? On a similar note, consideration needs to be given to claims on the shares by creditors of all shareholders. A benefit to having family members as shareholders is that it allows the

professional to spread his wealth amongst family members and protect that wealth against the professionals' creditors.

There are additional complexities for incorporating professionals that are currently members in partnerships that also need to be considered.

Professional practitioners should contact their advisors and consider the merits of incorporating in their particular situation.

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Readers are urged to consult their professional advisors prior to acting on the basis of material in this newsletter. If you have any questions regarding the content of this newsletter, please contact Crawford, Smith & Swallow. Copies of the newsletter in PDF format are available on our website: <http://www.crawfordsmithandswallow.com/newsletter.html>, Crawford, Smith & Swallow, Chartered Accountants, LLP

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